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THE 1987 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDREDTH CONGRESS

FIRST SESSION

JANUARY 22, 23, 29, AND 30, AND
FEBRUARY 2 AND 12, 1987

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THE 1987 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, JANUARY 22, 1987

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes, Melcher, Symms, and D'Amato; and Representative Wylie.

Also present: William R. Buechner, professional staff member.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator **Sarbanes**. Today, the Joint Economic Committee begins its annual hearings in conjunction with the Economic Report of the President for 1987, which will be presented to the committee 1 week from today—Thursday, January 29, at 11:30 a.m., by Beryl Sprinkel, the Chairman of the CEA. Testifying with him will be the other members of the Council, Thomas Gale Moore and Michael Mussa.

The purpose of the hearings that we've scheduled for today and tomorrow is to help set the context for review of the President's Economic Report when it's submitted next week. For that reason, we will focus on two issues of great importance at this particular time. Today's hearings will address the economic outlook for 1987. Tomorrow's hearing, which will be at 10 o'clock in room SD-628 of the Dirksen Building will be devoted to international trade and international economic policy. The witnesses will be Fred Bergsten, Lionel Olmer, and Gerald Holtham.

I want to take just a second to preface our discussion of the prospects for 1987 with a look at the economic performance in the year just passed.

Real GNP rose during the fourth quarter of 1986 at an annual rate of 1.7 percent according to the figures released this morning by the Commerce Department. This brought total growth for 1986 to 2.5 percent, which is in line with the growth rate of 2.7 percent in 1985 and, indeed, with the average growth rate of 2.4 percent for the entire period from 1981 through 1985, with the exception of 1984. It's interesting in this regard to note that the administration has revised its terminology in describing the growth rate of the past 2 years. The 1988 budget, which was released a couple of weeks ago on January 5, characterized the 2.5 percent rate as "moderate," whereas, in the budget presented a year ago, the same growth rate was described as "relatively sluggish."

I must say, by the standards of the postwar period during which the growth rate has averaged 3.2 percent, it would appear that "relatively sluggish" is the more accurate term.

In fact, a recent report from the American Enterprise Institute by Murray Foss noted:

> Although in its entirety and in its first year and a half, this expansion compares favorably with the two earlier ones, the experience since mid-1984 is troubling. When the latest nine quarters of the current expansion are compared with the corresponding periods in the two previous long expansions, the favorable picture disappears. Over the past nine quarters, real GNP has increased at an annual rate of only 2.5 percent, far below the 4.3 and 5.4 percent rates over similar phases of the earlier upturns.
>
> What is perhaps disturbing in the current scene is that nonresidential fixed investment has risen only 3.6 percent, whereas at similar phases in each of the two earlier expansions it grew much more rapidly and was clearly an important factor in the rise in total output.

Where inflation is concerned, performance has been more encouraging, in large part reflecting a decline in petroleum prices over the past year.

The GNP deflator rose 2.7 percent as compared to 3.3 percent in 1985. The CPI rose 1.1 percent during 1986, the smallest annual increase since 1961.

Furthermore, interest rates declined during the year by about 2 percentage points; nonetheless, real interest rates remain in the 5-7 percent range, significantly above the 2-3 percent level of the postwar period.

The encouraging downward trend in inflation has not been accompanied, however, by downward trends in unemployment. The civilian unemployment rate for 1986 averaged 7 percent, just two-tenths of a percentage point lower than in the preceding year; and, indeed, only one-tenth of a percent lower than in 1980. Despite the fact that total employment grew during the year by 2.4 million, 100,000 jobs were lost in manufacturing industries. In addition, there's evidence that we're losing relatively higher paying jobs and that net job creation in the economy is taking place at lower wage levels.

The deficit question, both the Federal deficit and the U.S. trade balance, of course continue to be major problems. We will address the trade deficit question in greater detail tomorrow. We have of course gone from being a creditor nation to a debtor nation for the first time since World War I.

It is with this sobering picture in mind that we turn to the question of the economic prospects for 1987. Here the administration's forecast, included in the budget submission early in January, serves as a touchstone for this morning's discussion.

The short-range economic forecast in the 1988 budget calls for the following in 1987: A real GNP growth rate of 3.1 percent; an increase in the GNP deflator of 3.3 percent, and an increase in consumer prices of 3.0 percent; a decline in unemployment for the total labor force to 6.7 percent and for the civilian labor force to 6.8 percent.

In looking at this forecast, we should recall that a year ago, the administration called for real GNP growth of 3.4 percent for 1986, a figure revised downward in August to 2.9 percent. And, of course, the final figure, as I indicated, is 2.5 percent. And the forecast for unemployment was 6.8 percent for the civilian labor force.

The administration's optimistic forecasts, which of course contribute to forecasting smaller Federal deficits, have outstripped the actual performance of the economy and have also run ahead of the forecasts of more neutral experts. Indeed, the latest Blue Chip economic indicators concensus forecast for 1987 calls for 2.4 percent real growth in 1987, an inflation rate of 3.2 percent and a civilian unemployment rate of 7.0 percent.

Against this background, we are fortunate to have three eminent economic forecasters this morning to dicuss the outlook for 1987.

They are Lawrence Chimerine, chairman and chief economist of Chase Econometrics; Donald Ratajczak, who is trying to make his way here from Georgia. He's the head of the Economic Forecasting Center at Georgia. It's cruel and unusual punishment to bring a Georgian to Washington in this kind of weather and we're not exactly sure where he is at the moment. But if and when he arrives, we'll promptly put him at the witness table. And Richard Rahn, the chief economist for the U.S. Chamber of Commerce.

Gentlemen, I think we'll take statements from each of you first and then throw the session open to questions.

And before we hear from you, I want to turn to my colleague, Chalmers Wylie, the ranking Republican on the House of Representatives side and a long-time member of the Joint Economic Committee and a very effective contributor to the work of the committee. Chalmers.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative WYLIE. Thank you very much, Mr. Chairman, for that nice introduction. And I want to return the favor to you and say that it will be a pleasure to work with you—I hope—although I'm not so sure yet it will be or not. [Laughter.]

But, I want to welcome the distinguished panel which we have here this morning to these annual hearings on the state of the economy.

And may I say that, based on the statement of the chairman, the GNP figures apparently will be the source of some discussion right off as to what the GNP figures are.

And I may say that my statement is a little bit more optimistic, based on, apparently, sources of figures from different economists.

But it seems to me that the current economic expansion is going well in its 5th year. Walter Heller had a report out this week, the University of Minnesota; and Mr. Richard Rahn also confirmed that in his—he's one of our witnesses here today—that real gross national product growth during 1987, year over year, will be about 3 percent, which is a little bit more optimistic than Senator Sarbanes' figures there.

But, for 1988, a survey of the 41 economic forecastors provided by Blue Chip's economic indicators, at least according to my figures here, show the real GNP growth concensus of 3.3 percent, which is a marked improvement over the figures that you just cited for 1987.

The Blue Chip forecast for the unemployment rate in 1988, according to these economic indicators, is 6.6 percent, which would be a decline for the forecast of 7 percent for 1987.

According to this same economic forecast, the concensus is that inflation and interest rates will remain low and under control.

So, to this member, the economy appears to be on a path of stable growth. We're comfortable with the current rate of inflation, hopeful that interest rates will continue to decline and we've got others this week that mortgage interest rates decline once again.

And optimistic that employment opportunities will continue to improve and confident about the Nation's resilient and innovative economic marketing. This is not to say that all is well.

Because our economy is dynamic and relatively free, it generates change and change causes uncertainty. This 100th Congress, the centennial Congress, faces many economic challenges.

Our primary responsibility, in my mind, is to design and implement policies which will strengthen, lengthen, and broaden the economic expansion, and I look forward to working with Chairman Sarbanes to that end. Thank you very much.

Senator **Sarbanes**. Thank you. Senator Melcher.

OPENING STATEMENT OF SENATOR MELCHER

Senator **Melcher**. I'll just draw the attention of the witnesses to some questions I'll be asking later. Since the basic commodity prices of both agriculture and energy have been low in the year just past, and they are currently low as we start this year, the effect of these low commodity prices in agriculture and energy on inflation in 1986 and the projected effect in 1987 and 1988 should be reserved some special attention. We also should consider the potential effect if U.S. policy is successful in improving agriculture commodity prices and if OPEC and Mexico are successful in improving the price of oil. Thank you.

Senator **Sarbanes**. Well, gentlemen, I think we're ready to go ahead with your statements. Mr. Chimerine, why don't you lead off, and then we'll go to Mr. Rahn. We appreciate very much your coming in this morning.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS

Mr. **Chimerine**. Thank you very much, Mr. Chairman. Let me start out by wishing you good luck during your tenure as chairman. I assume that 2 years from now, under your leadership, the committee will have found solutions to all of our difficult economic problem—if solutions can be——

Senator **Sarbanes**. I'm not sure that we're prepared to accept that——

Mr. **Chimerine**. If solutions can be found, I have every confidence you'll find them.

I have a prepared statement which I request be included in the record. And what I'd like to do in the next few minutes is to summarize what I think are the essential points regarding the current economic situation and the outlook for the next year or two.

And if we have some extra time, perhaps some thoughts about the longer term would also be appropriate.

Senator **Sarbanes**. Fine.

Mr. **Chimerine**. Let me start by agreeing completely with your opening statement. I don't know why this has happened but, in my judgment, the health of the U.S. economy has consistently been overstated during the last year or two.

The truth of the matter is that economic performance in recent years has been mediocre at best. Yes, the recovery is 4 years old, but most of it, as you pointed out, has been characterized by very slow growth. And since we had those two steep recessions before this recovery began, so that the economy was very depressed at that time, the level of economic conditions right now, based on historical standards, is poor.

As recently as 5 or 6 years ago, we would have considered 7 percent unemployment as unacceptably high in this country. And, essentially, that's what it's been for the last 2 or 3 years.

And the same is true with profitability, with capacity utilization, with GNP relative to its potential, et cetera. Most measures of macroeconomic performance indicate that we are operating far below potential.

And of course the third element of the current situation is the uneven pattern of performance—if you stop someone on the corner on Wall Street and you ask him about the economy, he'll probably tell you this is the greatest economic boom in history.

I doubt if you'll get the same answer in Moline, IL or Tulsa, OK, or many other places where, if you use the word "recovery," they don't know what you're talking about; where conditions are very, very weak.

And as long as we have a significant part of the economy operating in very depressed conditions, I don't see how anyone can claim that the economy is fully healthy and prosperous. So I strongly concur with your assessment of recent economic conditions.

I also agree there's been a marked improvement in inflation. But some of it is taking place not for the best reasons. It's happening because farm prices are depressed. It's happening because wages are being cut.

It isn't happening because we've experienced a surge in productivity in this country. That's the way we'd like to see improvements in inflation, and that has not happened during the last several years.

So, no matter how you measure overall economic performance, in my judgment, we have not particularly performed very well in recent years, despite the length of this recovery period.

Mr. Chairman, in my judgment, there is no evidence to support the view at this time that the economy is accelerating. As of right now, based upon a reasonably accurate reading of the economic statistics, which is very difficult because they become very erratic, and more importantly, the feedback we get from our large client base.

Essentially, the same pattern of slow and erratic growth that began in mid-1984, and has continued now since that time, is still in place, in my judgment.

If we are going to accelerate in 1987, it is thus not yet happening. And, by the same token, if we're going to have a recession this year—and I don't think we will, but if that were to take place, again that is not yet happening.

Fundamentally, all we can say is there's been no essential change in the underlying economic situation. Some recent statistics show a little more strength but, in my judgment, they primarily reflect some erratic movements and, second, some borrowing of economic activity from 1987 into late 1986, prior to the change in the tax structure.

When you adjust for that, again, I don't think there's been any improvement in the economy in recent months.

When I look ahead, starting with 1987, the most likely outcome is that this same pattern of slow growth or sluggish growth, to use the term you used earlier, Mr. Chairman, will continue during 1987.

We probably will avoid recession, but I think it's very, very unlikely we're going to see a major speedup in economic growth. And, as a result, I think this will be another year in which the administration's forecast will turn out to be optimistic.

I say that even though I agree with many others that we are likely to begin to see some improvement in our trade deficit during 1987.

But, I think it will be quite modest, for reasons I'll get to in a moment; and it will be offset by very, very sluggish growth in domestic economic activity.

So, even with the improvement in the trade deficit, I think it's highly unlikely that overall economic activity will accelerate during 1987. Why?

Why? Let me start with trade, because I think this is the key issue. If I might, let me take a minute to describe, at least in my view, why we've had these large trade deficits in the United States.

In my view, the major cause of our trade problems is a major change in our relative competitiveness in world markets. What happened is that many of the competitive advantages that we had back in the years immediately after World War II, particularly in the 1950's and 1960's, have been narrowed dramatically. In those days, you might remember, we were the undisputed leader in technology, both in developing new technology and in implementing and applying it; we were one of the few countries, except for Europe, that knew how to mass produce. We had giant productivity advantages in agriculture.

And most of our major competitors were ravaged by World War II. Other countries who could produce didn't know how to produce quality products—"Made in Japan" was a joke in those days.

As a result, we ruled the world economy. These productivity and competitive advantages allowed us to do so. We used those advantages to build up an income structure and living standards in this country which we could justify at that time. Now these competitive advantages have been narrowed or eliminated, because everybody else has the same technology—we gave much to them—they all know how to mass produce, they can produce the same high quality products that we can, and in some cases, better. They've narrowed the gap in agricultural productivity. They've recently rebuilt their infrastructures, so that their plant and equipment in many cases is more modern than ours in the United States.

Now that these productivity advantages have diminished, we can no longer afford, in my judgment, the income structure, or the cost structure, we put in place when we had these advantages. It didn't matter 20 years ago that wages were $1 an hour in Taiwan, because they didn't know how to produce anything. Now that they can produce, in many cases, the same products with the same quality that we can, that cost factor becomes extremely important. Thus, as a result, our trade deficit in recent years has widened because our competitive advantages have narrowed, and we now operate at a giant cost disadvantage in comparison with many other countries.

The economic policies that we have pursued in this country, particularly these mind-boggling budget deficits and the resulting overvalued dollar have made the problem even worse, but I think it started with a reduction in our competitive advantages, the ones that we enjoyed earlier.

Well, in my view, if that is correct, it means that the progress we make in turning the trade deficit around will be very, very slow, at best. It is going to take a while to overcome some of the quality disadvantages. It is going to take a long while to overcome some of the differences in labor costs between the United States, and particularly, the Far East. Many companies have shifted their production overseas. It will take many years to get them to reverse that. Some have dismantled their distribution networks overseas. You don't rebuild that quickly. Not only that, the dollar is still highly overvalued against almost all currencies except the Japanese yen and some of the European currencies. So what we gain, in terms of reduced trade deficit with those countries, we will at least partially lose against the other Far East countries.

And of course, with the recessions in OPEC and Mexico, it is very hard to export into those countries. Thus, at best, I think the improvement in the trade deficit will be very slow and gradual. It hasn't yet begun. I think it probably will begin in the next couple of months, and this will make a positive contribution to economic growth in 1987.

I think, however, that consumer spending will weaken, because many of the actions that are occurring in order to improve our competitiveness will come at the expense of living standards in this country. Many companies are cutting wages, and are laying off workers—both white collar workers and production workers. This is fine in terms of helping their competitiveness by cutting their costs, but it takes income out of the system.

In addition, the dollar is being pushed lower against some currencies. That is not a cost-free solution either. We are now beginning to see sizable increases in the prices of imported goods, that, added to higher energy prices, is already pushing the inflation rate higher, which will further squeeze purchasing power.

As you pointed out, Mr. Chairman, most of the new jobs we are creating are relatively low-wage jobs. So the shift in the job mix is also holding down purchasing power in the United States. In my judgment, we are now in the early stages of a sizable slowdown in consumer spending, because of these factors which are squeezing purchasing power, because of the high debt burden for consumers, and because of low savings, so that we will see very slow growth in consumer spending over the next year or two, very different than the pattern we had during the last couple of years.

Second, most companies are still cutting their capital spending budgets. They have lots of excess capacity. Real interest rates are still high. Many of them are having increasing difficulty in servicing the debt they have accumulated. This is causing them to cut back their current expenditures. Many of them have completed their modernization programs, or large parts of them. So capital spending won't be a contributor to economic growth.

Third, as you know, construction is overbuilt in almost all parts of the United States; in fact, with the exception of single-family housing, virtually every other type of construction is likely to be a drag on economic growth during 1987, because of all the overbuilding and because of the change in the tax laws. Fourth, Government spending is growing more slowly. Thus, based on the underlying fundamentals, it is unreasonable to expect, even with a modest improvement in trade, any pickup in economic growth from the 2 to 2½ percent rate that we have had now for the last 2 years plus.

There are some counterarguments you might hear. "Well, interest rates are going down. That will certainly stimulate faster economic growth."

I doubt it, Mr. Chairman. In my judgment, the Federal Reserve is pushing on a string. Real interest rates are so high for most borrowers that marginal additional reductions in interest rates are not having any significant effect on economic activity.

The only exception is in the housing sector, but with, you know, very little inflation in the commodity sector and manufacturing, interest rates are still so high that inventory patterns are not changing and capital spending isn't being accelerated. In addition, the economy is loaded with debt and a lot of previous pent-up demand has been used up. And we have all the overbuilding I talked about earlier—I doubt if a construction company in Texas is going to build another empty office building because mortgage rates have dropped a little bit. We have enough empty office buildings already.

In sum, the conditions which exist now are such that modest reductions in interest rates do not have much of a stimulative impact, and I do not believe, therefore, that that will produce stronger economic growth. Quite the contrary. We need lower and lower interest rates just to keep the economy in the same place, in my judgment.

The second argument you might hear is, "Well, inventories are low throughout the economy. Companies are going to start rebuilding those inventories. That will generate new orders, new production and new jobs." That argument would give one the impression that the reason inventories are low is that goods are jumping off everybody's shelf. That is not the case at all. Inventories are low because companies are deliberately downsizing their inventory levels, because prices are weak in many cases, because interest rates or carrying costs are still high, because the sales outlook is uncertain, and because they are trying to conserve cash. In addition, lead times are short. In this environment, no one wants to hold inventory, so that we are not going to get an inventory-led pickup in the economy.

And then you hear a third argument. "Well, the stock market is booming. That must be telling us something."

I don't think so. In my judgment, the boom in the stock market is, in part, a reflection of weakness in the economy, because more and companies are finding it better to buy back their own stock, or do a leveraged buyout or buy up somebody else's stock, than to engage in more fixed investment.

Fundamentally, we have an economy which is awash in liquidity, because of an easier Federal Reserve policy, and that liquidity is going predominantly into financial assets. It is not going into the real economy. Financial assets look favorable because of lower inflation and because of lower interest rates and because commodities are oversupplied and real estate is losing its tax advantages. Furthermore, the market did very poorly in the 1970's and early 1980's—perhaps we are catching back up for that now.

Fundamentally, we are seeing an increasing shift into financial assets, but I don't think it tells us anything about the current strength of the economy, or the expected strength of the economy.

When I add it all up, it's more of the same, in my judgment—very slow growth for the next year or two. There is also a real risk of recession this year, particularly as the auto companies start cutting production and if we get some nasty surprises from tax reform over the next 6 months. My best guess is that we will avoid a recession, but we will have very slow growth at best.

And if I might make one final comment, Mr. Chairman, 10 years from now when we look back at this period, we may find that we witnessed a long period of extremely slow growth by historical standards. It is being caused by our competitive problems, by the effects of the debt buildup that has been incurred in recent years, and by the counterproductive effect of budget deficits. We thus may now be in what will turn out to be a very long period of slow economic growth in comparison with the standards of performance that we experienced in this country in earlier periods. Thank you.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine, and I am the Chairman and Chief Economist of Chase Econometrics. I am delighted to have this opportunity to testify before the Joint Economic Committee on the outlook for the U.S. economy for 1987. In addition, I would like to address some key economic concerns and their implications for longer-term economic performance.

SUMMARY

In sum, my views are as follows:

(1) Despite the fact that the current recovery is more than four years old, the recovery process has not been completed. The economy is far from being fully healthy and prosperous.

(2) Despite some uptick in several recent statistics, the long period of slow and erratic growth that has been in place since mid-1984 appears to be continuing. Thus, at this point, there is no conclusive evidence of either a major acceleration in the economy, or of a slide into recession.

(3) Slow growth is continuing because the stimulative impact of declines in oil prices, interest rates, and the U.S. dollar, and the boom in the stock market, are providing only modest stimulus. In addition, various other negative factors are holding down economic activity.

(4) The underlying fundamentals suggest that this pattern of slow growth will continue during 1987 -- in particular, despite some anticipated improvement in the trade deficit, slower growth in consumer spending, weakness in capital spending, cutbacks in government expenditures, and very weak construction, will combine to hold economic growth to the 2% to 2.5% range, with several significant downward risks.

(5) The slow growth now underway may in fact continue for many years, in part reflecting the deterioration in U.S. competitiveness in world markets, and the enormous debt buildup in recent years.

(6) It is essential that budget deficits be reduced in an orderly way, and also that it be done in such a way as to not further jeopardize U.S. competitiveness. In particular, higher spending may be necessary for education, job training, etc. -- in order to finance these and still reduce budget deficits, some tax increases may be necessary, along with cutbacks in entitlement benefits to high-income individuals.

THE RECOVERY THUS FAR

The recovery which began near the end of 1982 is now more than four years old -- this makes this recovery period one of the longest on record. However, the health of the economy has nonetheless been overstated because of a lack of understanding of many aspects of the recent economic situation. These include the following:

(1) There have been two very distinctly different parts of the recovery period. The first eighteen months (or all of 1983 and the first half of 1984) was characterized by extremely rapid growth (over 7% at an annual rate as measured by real GNP). However, the two and one-half years since that time have witnessed a dramatic deceleration in the rate of growth to an extremely sluggish 2.5% average rate -- this is well below the historical average, so that only marginal additional progress at best has been made toward completing the recovery process. This is best illustrated by the fact that unemployment, capacity utilization and other measures of economic performance have shown no significant additional improvement since mid-1984. And, because of the dramatic slowdown since mid-1984, growth during this recovery in total is now below the rate experienced in most other postwar recovery periods -- and the 2% average growth since 1980 is far below that experienced in previous postwar decades.

(2) This period of extremely slow growth has taken place even though the level of economic conditions has not been satisfactory. This reflects the fact that the 1981-82 recession followed closely on the heels of a previous recession, so that economic conditions were extremely depressed when this recovery period began. Therefore, virtually all measures of economic performance are still unacceptable. For example, the near 7% unemployment rate that has prevailed during the last two years is obviously a significant improvement over the near 11% rate of late 1982, but it is still much higher than at anytime in the postwar period prior to the 1980s with the exception of the 1974-75 recession.

(3) The performance of the economy during the past several years has been highly uneven, with many sectors still mired in recessionary conditions. This has created major industry and geographic differences which are causing severe hardships in many areas.

In sum, the performance of the economy in recent years, at least with respect to real economic growth, has been vastly overstated -- the recovery in total has not been particularly strong and is far from complete; we have experienced only marginal additional progress in completing the recovery process during the past two and one-half years; and the economy is still operating at highly unsatisfactory levels by historical standards.

THE CURRENT ECONOMIC SITUATION

Despite some uptick in recent statistics, the economy is still growing at a relatively slow pace in my judgment. The uptick in some of these recent data is exaggerated by the following:

(1) While employment and industrial production did rise more strongly in November and December, and while unemployment fell in December, it appears that these gains have been exaggerated by unreliable seasonal adjustment factors. In addition, it seems clear that some economic activity has been shifted from 1987 into the latter part of 1986 prior

to the effective date of the new tax structure. In particular, some sales of autos and consumer durables were borrowed in advance in order to qualify for full sales and interest deductibility; some orders and shipments of capital goods have been accelerated in order to qualify for higher depreciation; and activity on various construction projects was expedited, also to permit more rapid depreciation.

(2) While retail sales in December rose very sharply, most of the gain was in auto sales, for reasons discussed above. The 0.9% rise in nonauto sales may also have been inflated by that factor -- in addition, it follows a downward revised 0.5% decline in such sales in November, so that the two months together show very little gain. The likelihood that some sales were borrowed from the future is consistent with reports from retailers and auto dealers, which indicate very sluggish sales thus far in January.

(3) Not only did the trade deficit reach an astounding $19.2 billion in November, but the October deficit was revised upward. Furthermore, a significant part of the November deficit was the result of large carryovers of imports from previous months, suggesting that the trade deficit did not improve in those months.

On balance, therefore, when the likelihood of erratic movements in the data are coupled with revisions to earlier data, and the effects of tax reform, it appears that no major change in the underlying situation has taken place -- this is confirmed by feedback from Chase Econometrics clients.

WHY HASN'T THE ECONOMY PICKED UP?

The sluggishness has continued despite numerous forecasts that a major acceleration would take place during 1986 because of declines in interest rates, the dollar, and oil prices, and other apparently favorable factors. However, the economy has not picked up for the following reasons:

(1) The sharp decline in interest rates that has occurred since late 1984 has had only a small stimulative effect on the economy thus far, since real interest rates were extraordinarily high when these declines began. Thus, in effect, rate declines were necessary just to keep the economy in the same place, and in great part have been caused by the weak economy. The only noticeable effect of the decline in rates thus far has been on the housing industry -- real interest rates for industrial companies are still so high that there has been virtually no impact of recent declines in nominal rates on capital spending plans or on inventory policies. The impact of declining interest rates is also being limited by the age of the recovery, the winding down of previously available pent-up demands, and already high debt burdens, which have reduced the willingness of both corporations and households to incur additional debt. Thus, the Fed is in great part pushing on a string.

(2) The economy has not yet experienced any significant benefits from the sharp decline in the value of the dollar. First, the decline which

took place during 1985 and most of 1986 had little or no effect on U.S. competitiveness in world markets, since it primarily squeezed what had been enormous profit margins of foreign companies selling in U.S. markets. Only in the last few months have prices of imported products begun to rise significantly on a widespread basis -- as is well known, it will take many months before these price changes begin to affect real trade flows. While these price increases will eventually slow import penetration somewhat, the impact will be limited by the fact that many imported goods have no domestically produced counterparts, by the perception that some have higher quality than comparable domestically produced products, and by the increased familiarity of American citizens with foreign produced goods. Second, recent increases in imports, and softness in exports, to some extent reflect the impact of earlier outsourcing decisions as many new overseas plants become fully operational. Third, the U.S. trade deficit with Canada, Latin America and the developing countries in the Far East, continues to grow, in part because of weak economic conditions and debt problems in some of those countries, and in part because the currencies of most of those countries have not appreciated relative to the U.S. dollar. Fourth, the sharp decline in the price of oil has caused cutbacks in U.S. oil production -- this has already led to increases in the volume of imported oil. Furthermore, most OPEC countries and other major oil exporters are beginning to slow their imports from the United States and other countries because of the impact of declining oil prices on their already poor current account positions. Finally, domestic demand is still weak in much of Europe and Japan.

(3) The stimulative impact of lower oil prices on the economy has been modest, at best. In great part, this reflects the fact that the United States is a large producer of oil (we produce about 70% of our own needs), so that the main benefit to the United States economy of declining oil prices has come from a decline in the price of imported oil. However, oil imports relative to GNP have fallen sharply since the early 1970s (by more than 50%), reflecting that fact that we consume far less energy relative to the size of the economy than we did then, that oil now constitutes a smaller fraction of our total energy consumption than at that time, and that we produce a larger fraction of our internal needs ourselves. The negative effects of lower domestic oil prices on profits in the oil industry caused sharp cutbacks in employment, and in exploration and other investment. These represented very sizable offsets to the gains to consumers, and profits to oil users, that resulted from lower domestic oil prices. Furthermore, because of already large current account deficits, most OPEC countries are reducing their imports of military and manufactured goods from the United States and other countries, which is offsetting part of the favorable effects of the lower cost of imported oil (as mentioned earlier).

(4) In my view, the stock market boom does not reflect either current or expected economic strength -- in fact, the rise in stock prices is more accurately a sign of weakness, since it largely reflects the sharp decline in interest rates, which in turn is a direct result of the sluggish economy. In effect, what has happened is that the substantial increase in liquidity that has been pumped into the

economy by the Federal Reserve has gone into financial assets rather than fixed assets, reflecting the lack of viable fixed investment opportunities due in part to overcapacity, overbuilding, etc. Thus, many companies have found it more attractive to buy up their own stock, or someone else's, rather than making investments in plant and equipment. Furthermore, the sharp increase in the value of financial assets held by consumers is also vastly overrated as an economic stimulant, since: (a) ownership of financial assets is concentrated among relatively high income families with a relatively low marginal propensity to consume, (b) most individuals cannot gain access to these funds because they are tied up in pension accounts, and (c) many of those who have experienced capital gains have rolled them over rather than using them to finance consumption. In addition, household debt has risen dramatically during this period, with a far more widespread distribution across the population.

(5) Many forecasters had predicted an inventory-led acceleration in economic growth in 1986, reflecting the relatively low inventory/sales ratios which prevailed at the end of 1985. However, inventory/sales ratios have not been low because goods have been jumping off the shelves -- they have been deliberately reduced by manufacturers and retailers because of: (a) extremely high real interest rates; (b) large excess capacity; (c) relatively short lead times; (d) the still weak prices of many finished goods and commodities, and the uncertain price outlook; (e) the uncertain sales outlook; and (f) weakness in profits. The downsizing of desired inventory levels is in fact continuing, so that inventories are still a neutral factor at best in the economic situation.

(6) Some forecasters also predicted a surge in the economy as a result of sharp increases in the basic money supply during the last eighteen months. However, there is currently almost no relationship between M1 and economic activity, reflecting: (a) continued increases in import penetration, which increases the demand for credit and the money supply without increasing domestic output; (b) declining interest rates, which have reduced the opportunity costs of holding interest free or low interest deposits; and (c) concerns regarding the safety of deposits at various thrifts and other financial institutions, which has caused a shift of savings into M1 types of deposits.

THE OUTLOOK FOR 1987 AND 1988

I expect economic growth during 1987 and 1988 to remain close to the average rate of growth of 2.5% since mid-1984. The forecast arithmetic is essentially composed of three parts.

(1) Real consumer expenditures should rise at 2% - 2.5% for the foreseeable future (down sharply from the rate of increase during 1985 and 1986), thus contributing approximately 1.5% per year to GNP growth during 1987. This reflects a continuation of extremely slow growth in wages and salaries and other components of personal income -- furthermore, inflation is now accelerating to the 4% range, because the decline in energy prices (which boosted purchasing power and consumption in 1986) is now largely over, the prices of many services

are still rising, and the weaker dollar is causing upward pressure on goods prices. Thus, real income growth will average only about 2% during the next two years. In addition, the sharply higher consumer debt burden, which has led to a significant increase in delinquencies will prevent many families from continuing to finance a large fraction of new expenditures by borrowing, especially since the saving rate is now at or near an all-time low. Finally, previous pent-up demands for consumer durables have been largely satisfied. The subdued outlook for consumer spending is also consistent with recent surveys of consumer attitudes and expectations, which on balance show that confidence is now somewhat below levels earlier this year.

(2) Despite the large November trade deficit, I nonetheless continue to expect that a modest turnaround will begin shortly -- on a fourth-quarter to fourth-quarter basis, the trade deficit should decline by approximately $20 billion in real terms during each of the next two years, adding about 0.7% to annual GNP growth. This is supported by recent increases in export orders for chemicals, paper, certain textiles and commercial aircraft; in addition, price increases for Japanese and European imports are now starting to spread, which will slow import penetration during the forecast period. It should be noted that a more rapid turnaround in trade is unlikely, for reasons discussed later.

(3) Nonconsumption domestic demand will add very little to GNP growth during 1987; this reflects: (a) While construction put-in-place for most types of structures remains relatively strong because work is continuing on the large number of new projects that were begun earlier, (and in fact, had been accelerated on many to insure completion before depreciation becomes less favorable), new activity is declining. In particular: (i) Housing starts peaked earlier this year -- the modest downward trend will continue through most of 1987, especially for apartments and condominiums. (ii) New contracts for commercial and industrial construction remain about 25% below year-earlier levels, with no upturn likely for several years. (iii) While the worst of exploration cutbacks appears to be over, oil prices are still too low to justify any sustained increase in drilling. (iv) Public works construction (primarily highway maintenance) is likely to taper off in response to reduced Federal funding and state and local government budget pressures. (b) Capital spending plans for 1987 indicate a relatively weak year -- this is consistent with recent cutbacks in appropriations by many corporations. The relatively unfavorable underlying factors affecting capital spending are unlikely to change anytime in the near future -- these include the still low operating rates across a broad spectrum of the economy, the uncertain sales outlook, high real interest rates for most industrial companies and commodity producers, and the adverse effect of tax reform on the cost of capital and on expected cash flow. (c) Fiscal policy is becoming far less stimulative, reflecting the modest budget cuts that have been enacted -- in addition, rising interest payments, which now comprise an increasing share of budget deficits, have a relatively small multiplier effect. Furthermore, I continue to believe that tax reform will have an additional negative effect on the economy in 1987, because not all of the automatic increases in state and local taxes caused by the broadening of the Federal tax base will be offset by

newly legislated tax cuts. (d) Still cautious inventory policies will be maintained by most U.S. companies.

The net effect is for real GNP growth of about 2.3% during 1987, and only slightly higher during 1988. Furthermore, I continue to believe that the risks are predominantly on the downside during 1987: (a) Plant closings and production cutbacks in the auto industry may be even somewhat greater than now expected -- moreover, the loss of income and consumer confidence caused by auto layoffs could cause even weaker consumer spending. (b) It is possible that the turn in the trade deficit could begin somewhat later, and/or could be somewhat slower, than now expected. (c) The change in the tax structure on January 1 may have more adverse transitional effects than now expected.

LONG-TERM OUTLOOK

Trade Deficits and Long-Term Growth

It is generally expected that the U.S. trade deficit will decline during the years ahead, that these declines will add between 0.5% and 1% per year to average economic growth (reversing the pattern during the last several years), and that this reversal will permit overall growth to approach its near 3.5% long-term average. As discussed earlier, I share the expectation that the trade deficit will soon begin to decline, and that this trend will continue over the long-term -- in fact, such an outcome is almost essential because U.S. foreign debt would otherwise reach levels that would be both unsustainable and potentially highly destabilizing. However, a decline in the trade deficit does not necessarily imply that economic growth will accelerate -- it implies only that output growth will exceed domestic spending.

I, in fact, believe that economic growth in the United States will lag behind the postwar average for many years, despite a falling trade deficit. One reason for this expectation is that a major factor which produced the staggering U.S. trade deficits has been a narrowing during recent years (or elimination in some cases) of the competitive advantages that the United States enjoyed after World War II. These advantages resulted from the development and implementation of new technology, the use of more sophisticated mass production techniques in manufacturing, the mechanization of agriculture, etc. -- they caused average productivity in the United States to far exceed that of other countries (and the gap to widen) for many years.

The "catching up" of the rest of the world during the last 15 years appears to reflect a number of factors, including the spreading of technology throughout the world, the rebuilding of war-ravaged infrastructures in Japan and much of Europe, and investments in new and modern facilities in many other countries. However, the earlier U.S. productivity advantages were used to raise wages and income levels substantially throughout much of the economy -- these increases in wages have now produced an enormous disparity in labor costs, which, when combined with differences in capital costs, can no longer be justified by productivity differentials. This deterioration in relative U.S. competitiveness is evidenced by the rise in the U.S. bilateral trade deficit with Japan and some other countries during the late 1970s and early 1980s -- several temporary factors, including surges in bank-financed exports to Latin America and oil-financed exports to the Middle East, as well as an undervalued U.S. dollar (especially in relation to European currencies), temporarily bolstered our aggregate trade performance at that time despite the deteriorating fundamentals. When these temporary factors were reversed, the U.S. trade balance began to worsen rapidly --enormous budget deficits and the overvaluation of the dollar in recent years accelerated this trend.

While efforts have been made to improve productivity and lower costs in the United States in the last several years, it seems clear they have not been enough to improve U.S. competitiveness sufficiently to bring about a sharp decline in future trade deficits. First, while productivity growth has accelerated in manufacturing, aggregate productivity growth still remains disappointingly low. And, much of the improvement in productivity in industry reflects layoffs, rather than benefits from the increased use of new technology or more efficiency in the manufacturing process -- this process can't be repeated indefinitely, especially since many of the employment reductions have been among managerial and nonproduction workers. Many U.S. industries thus are now experiencing the worst of both worlds --falling employment and continued erosion in market share. Second, while many companies have frozen or even cut wage rates (in addition to staff reductions), wage levels remain far above those in many other countries (especially the Far East NIC's). Third, efforts to improve efficiency and reduce costs are being implemented in Japan and other countries, offsetting some of those being made in the United States. Finally, the decline in the dollar thus far has had only a modest affect on U.S. competitiveness because it has been limited to the Japanese yen and the major industrialized countries in Europe.

In view of these factors, and of the continuing sluggish conditions in many other parts of the world (which will hold down U.S. exports), I thus believe that a combination of additional dollar declines (some are now happening) and slower growth in domestic demand will be necessary to bring trade deficits down even modestly in the future:

(1) Underlying productivity trends suggest that the trade-weighted average of the dollar in real terms may have to fall to, or below, the early 1980s levels in order to produce the same degree of relative competitiveness which existed at that time. This trend implies a continued upcreep in inflation as dollar declines are increasingly reflected in higher prices for imported goods, and as prices of domestically-produced competing goods are raised in response.

(2) Barring even sharper declines in the dollar, a long period of relatively slow growth in domestic demand will also be necessary to bring the U.S. trade deficit down -- each 1% decline in the growth of domestic demand in the United States will reduce the growth in real imports by approximately 2%, thereby cutting the trade deficit by about $8 billion per year (on a cumulative basis). I especially

believe that growth in consumer spending will be sluggish for many years, reflecting the effects of cutbacks in white and blue collar employment and wages, and declines in the value of the dollar, on household purchasing power (real wages already are stagnating, as discussed earlier). This conclusion is reinforced by data indicating that wages and salaries among the job losers in recent years have been above the average in most cases, and that wages for a large fraction of the new jobs that have been created have been below the average. While the increase in prices caused by dollar weakness will help bolster profits, I do not expect this to translate into larger wage increases or employment gains for at least several years in view of the desire of many companies to rebuild profit margins, and in view of relatively high unemployment in many sectors.

Implications of the Debt Buildup

An enormous and unprecedented buildup of debt has occurred in the United States during the last five years -- during this period, total nonfinancial debt has increased at a rate more than twice as fast as nominal GNP, pushing the total debt-to-GNP ratio up sharply after more than 30 years of stability. The rise in debt has even far outstripped the growth in domestic demand, so that the adverse effect of the growing trade imbalance on real output explains only a small portion of the rise in the debt/GNP ratio. Corporations, households and the Federal Government have all significantly increased their indebtedness during this period.

These high debt levels, may well limit economic growth for many years, for the following reasons: (a) Delinquency rates for consumer loans, and corporate defaults and bankruptcies, have increased sharply, indicating that at least a portion of the economy has become overburdened. Furthermore, for the remainder of the economy, the ability to continue financing a large fraction of current expenditures by borrowing has diminished greatly because debt servicing has increased significantly relative to cash flow and household incomes. In fact, there is evidence that the buildup of corporate debt in recent years is now causing cutbacks in capital spending -- this will not only prevent a stronger economy in 1987, but could actually hinder growth in the longer term. (b) The large buildup of debt has been used primarily to finance budget deficits, consumption, and financial transactions, rather than investment -- thus, it will not yield improvements in productivity, competitiveness, etc. that could increase potential growth, and generate higher incomes to both service the debt and stimulate spending. (c) The massive accumulation of debt in recent years has been financed in part by borrowing from overseas -- the increasing cost of servicing this rapidly growing foreign debt will slow long-term growth by transferring dividends and interest payments out of the U.S. economy.

In addition, the difficulty in servicing the larger volume of debt may make future recessions more steep, especially since any further increase in defaults and delinquencies will weaken the already fragile financial system (bank failures continue to increase even though the economy is still growing). The corporate sector is especially more vulnerable to an economic slowdown, or higher interest rates, because it has not only been adding debt at record levels, but it has also been redeeming equity since 1984, making it more leveraged. The risks associated with the more highly leveraged corporate sector is being exacerbated by the increased portion of bank lending to more risky borrowers.

Economic Restructuring

It is commonly argued that the United States is now going through a major restructuring, from a largely manufacturing to a services-based economy, in the same way that it moved from agriculture to an industrial economy earlier. Furthermore, many argue that this adjustment process is now almost over, so that the economy will begin to grow more rapidly. However, the industrial revolution came about primarily because of rising productivity in agriculture (which freed resources), and resulted in a shifting in resources to even higher productivity manufacturing. Thus, it added to potential long-term economic growth.

The restructuring now taking place is in part being forced by diminishing competitiveness in world markets, rather than because of rising productivity. Moreover, while some of this shift is now into high value-added and productivity activities, involving the use of new sophisticated technology, a large fraction of new jobs are in relatively low-wage, low productivity occupations and industries -- this is holding down overall productivity growth. The current restructuring is also being accompanied by an enormous buildup in corporate debt, which potentially will reduce competitiveness even further (as discussed earlier). Thus, I believe it is optimistic to expect that the restructuring now taking place will produce significantly faster growth in the next five or ten years.

Long-Term Growth Prospects

The combination of poor underlying competitiveness in world markets and high debt levels, combined with relatively slow productivity growth, the continuing loss of high-paying jobs, and other factors, suggests that the pattern of slow growth (by historical standards) that is now underway in the United States may continue for many years. In particular, since some of the factors that permitted the rise in living standards during the 1950s and 1960s are no longer as favorable, since the growth in two-income families and household debt will slow, and since the recent low inflation rate caused by a rising dollar and declining oil prices will not be repeated, spending can no longer grow at anywhere near the rate of recent years. Furthermore, this will represent the other side of trade deficit reduction, so that overall economic growth will not accelerate significantly.

POLICY IMPLICATIONS

While many of our current problems cannot be quickly addressed by economic policy, I would nonetheless suggest the following:

(1) Budget deficit reductions remains essential. However: (a) the

reduction should be gradual so as not to further weaken the economy in the short term (about $25 billion per year would be reasonable, producing a targeted deficit of about $100 billion in 1991 rather than a balanced budget). Thus, the current Gramm-Rudman-Hollings targets should be abandoned. (b) Budget policy should be formulated to address other priorities as well. Thus, some additional funding for education, rebuilding the infrastructure, job training, etc. may be necessary even as budget deficits are reduced -- this will require cutting spending for entitlements by converting some to means-tested programs (at least in part) and by other changes, as well as some revenue increases. (c) Future tax increases should be designed in such a way that they do not further shift the tax burden away from upper-income groups as in recent years.

(2) There is no way that our competitiveness in world markets can be improved with one simple policy measure. It will require a thorough evaluation of our educational system, our training programs, our military expenditures, our trade laws, etc. It is imperative that this process begin as soon as possible because of the long lag before new actions will begin to have a material effect. Trade legislation should focus on improving U.S. competitiveness and opening foreign markets rather than on protectionist devices.

(3) All economic and tax policy actions in the future should be evaluated as to whether they improve U.S. competitiveness and growth prospects before enactment.

Senator **Sarbanes**. Thank you very much. Mr. Rahn.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. **Rahn**. Thank you, Mr. Chairman. I do appreciate the opportunity on behalf of all the members of the U.S. Chamber of Commerce to speak before you today. I too have a prepared statement which I request be included in the record, and I will summarize my thoughts in the interest of time.

Senator **Sarbanes**. Fine, both of the full statements will be included in the record, as will the one that Professor Ratajczak submitted to the committee, whether or not he makes it here today in person. Please go ahead, sir.

Mr. **Rahn**. I should note that I am a bit more optimistic that my colleague. We are already into the 18th quarter of the economic recovery. And this recovery has defied the conventional wisdom. When it began many economists and pundits said that a recovery without rampant inflation was not possible. That turned out to be totally untrue and much of what has been written over the years about this recovery has also turned out to be wrong. As with all economic expansions, this has been an uneven one. Automobiles have done particularly well and have enjoyed a record period of expansion. Residential construction has also done well. On the other hand, net exports have done very poorly. Most recently, we have had the difficulties in the oil patch.

The best news, of course, is inflation numbers. We've had a steady decline in inflation during the past 24 years, and the latest data shows that last year we had the lowest rate of rise in consumer prices in 25 years.

Equally important is the rise in total employment. I think the best measure of employment health is the percentage of the adult workforce employed, which is now at a record high level. In fact, it's the highest percentage for any of the major industrial countries. The unemployment rate now seems to be dropping rather rapidly, and we are quite optimistic on that.

During the first 2 years, the recovery was far stronger than the postwar average. But over the past 2 years, growth has been rather sluggish. Part of the reason for the slower growth in 1985 and 1986 is that the 1981 tax rate reductions were whittled away by a series of tax increases which have now resulted in virtually no net tax reduction at all from the 1981 level.

We are now entering the fifth year of the economic recovery. Most economic indicators point to moderate economic growth this year and next. We expect about a 3 percent GNP growth rate this year and 3.2 percent next year. While our forecast is slightly more optimistic that the consensus, it is not out of line with it. One of the signs that indicate that the economic outlook is good is the stock market.

I have a little more faith in what the stock market is doing that my colleague Mr. Chimerine. I don't think people put their money on the line unless they see opportunities for real profits. In the past the stock market has been probably as good a forecaster as the professional economist.

We see no sign of a recession. We must remember that recessions come from policy mistakes and not from old age. They usually result from rapidly rising interest rates or rapidly rising inflation, a big rise in labor costs, high capacity utilization rates, and excess inventory accumulation. The U.S. economy is not facing any of these constraints at the present time.

The outlook for incomes and consumption is also positive. There's been a lot of talk about the fact that new jobs that are now being created are low-paying jobs. This has always been the case. We do not increase the number of "Fortune 500" presidents, regardless of the strength of the economy. The new jobs are formed at the bottom and people work their way up over time. A better indication of progress is real after-tax income. From 1973 through 1983, that measure of adjusted income fell; this is a source of great concern to many of us. Since 1983, however, it has been rising, not as rapidly as we'd like to see it rise, but at least the trend is in the right direction. We need to do much more to accelerate that progress in income. I think that the real focus of economic policy ought to be an increase in real per capita income for all our citizens.

There are a number of policy risks facing the economy at the moment. A major tax increase, in our estimation, would be a disaster for the economy. Tax revenues as a percentage of GNP are now at about their historical average for the past 22 years. The problem we are facing is not insufficient revenues. I think we've learned from bitter past experience that big increases in taxes, and particularly high marginal tax rates or big increases in the taxation of capital, are destructive and counterproductive. The tax liability of the wealthy has increased since the 1981 tax changes. The rich are now paying a higher percentage of their incomes in taxes and a higher percentage of the total tax bill than are the lower income groups. To me, this is constructive tax reform.

Our big problem here is failure to contain spending growth. I think that the empirical evidence is now rather overwhelming, both for the United States and for other industrialized countries, that as Government spending grows as a percentage of GNP, it reaches a certain point where it becomes counterproductive and leads to sluggish economic growth rather than to more rapid growth. And clearly, the United States and the major Western industrial countries are well beyond the point where any increase in Government spending, as a percentage of GNP, would be a positive for the economy.

We are concerned about the lack of a resurgence in export growth. I was just glancing at the GNP figures that were released this morning; it's encouraging to see a nice pickup in exports for the fourth quarter. Of course, that doesn't really mean a trend. The so-called "J curve,"—the lag between changes in the value of the dollar and changes in exports—is quite long, 18 months to 2 years. We are at about that point now so I do think we will see some improvement soon. However, the main determinant of our export performance in the coming months is going to be the strength of the economies that we export to. In this regard we are very concerned about what I consider the too stringent economic policies, particularly in West Germany and Japan, but also in much of Europe. I think that their policies could be more expansionary.

Because of their very high debt overload, the developing countries are not going to be a source of demand for U.S. exports. I do expect a turnaround, but it depends, again, on the actions of the other industrialized countries. Obviously, our ability to bring that about is limited.

I am also very concerned about the possibility of enactment of short-sighted protectionist legislation which could trigger retaliation, increased cost and a possibility of a worldwide recession. Some of the proposals brought before the U.S. Congress would clearly not be in our national self-interest or in the interest of the world economy. We must do everything we can to avoid high tariffs, counterproductive quotas, and so forth, which would greatly increase costs to American consumers. If history is any guide at all, we should know that these actions have seldom opened up other markets, and in virtually all cases they reduce real income levels rather than increase them.

We are also concerned about the initial negative impact of the tax reform legislation. The U.S. Chamber of Commerce supported the tax reform legislation, but with great reservations. We are particularly concerned about the effects on heavy manufacturing. Many of the old-line metal firms, stock chemicals, and so forth, were very adversely affected by the removal of the ITC and the cutbacks in accelerated depreciation. We think this was a great step backward, particularly at a time when we are so worried about our international competitiveness. This has increased the cost of capital relative to that in our major industrial competitors, and in our judgment, we should have done just the opposite. Capital should be taxed at the present value equivalent of expensing. That is what is economically sound. We are not doing that. Current law has a strong bias against long-term investment capital.

Moreover, the increase in the capital gains tax is clearly counterproductive. The empirical evidence shows that lower tax rates on capital gains result in higher government revenues, and also strengthen the venture capital market.

I have no doubts at all that new venture capital, R&D investment, innovation and government revenues are going to suffer as a result of the increase in the capital gains tax rate.

I'm also concerned about the very rapid growth in the money supply. Over the last 13 weeks, M_1 has increased at a 25.4 percent annualized rate. Over the last 52 weeks, it went up 17.6 percent.

While it may be true that the old relationship between M_1 and nominal GNP may have broken down, this rapid increase is, nevertheless, alarming. Given this very rapid monetary growth, you almost have to forecast a huge increase in real economic growth or a big drop in velocity in order to avoid a surge in inflation, particularly coupled with the climb in the U.S. dollar.

The enactment of protectionist legislation, combined with the rapid monetary growth and the dollar's depreciation could result in a significant reacceleration of inflation. I think it is now avoidable and we are cautioning the Fed to look at this a little more carefully and be very sensitive to any rise in basic commodity prices, but that is a major source of concern for us.

Our policy recommendations are, first, Congress ought to do its best to meet the Gramm-Rudman targets without any kind of major tax increase. In this regard, it is not necessary to reach a particular figure, what is important is the notion of bringing down the deficit in real terms.

Progress has been made over the past year, and we encourage you to do everything you can to continue that progress.

The past few years one of our biggest problems has been the constant changes in the tax law. This has led to an enormous amount of business uncertainty. Surveys of our own membership clearly reveal that businessmen are reluctant to invest, or always assume the worst case tax scenario when they invest because the tax treatment of investment is so uncertain.

For instance, the ITC has been repealed and reinstated three times in the last 15–18 years. It seems as if every year there's a change in how depreciation is taxed. Moreover, the changes themselves have had a very destructive effect on new capital formation.

We experienced a big drop in business investment spending this past year. Here again, the feedback we get from our members, which directly or indirectly, involves virtually all the major industrial companies in the country, is that the uncertainty about how they will be taxed was a major depressant on their investment plans.

If we make any changes in the tax law, let's try to increase our competitiveness by again finding a system to give businessmen present value equivalent of expensing and providing a more realistic and internationally competitive capital gains tax rate.

Finally, in the area of trade, we know that many markets are basically shut to U.S. exporters. The Japanese, in particular, have been gross violators of the principle of free trade.

The trick for all of you is to find ways of enacting constructive trade legislation so as to encourage these countries to open their markets without shooting ourselves in the foot in the process.

Mr. Chairman, with that, I would be more than pleased to answer any of your questions. Thank you.

[The prepared statement of Mr. Rahn follows:]

PREPARED STATEMENT OF RICHARD W. RAHN

I am Richard Rahn, Vice President and Chief Economist of the U.S. Chamber of Commerce. On behalf of the Chamber's membership, I welcome this opportunity to present our views on the economic outlook for this year and next and to share with you our concerns regarding the policy risks facing our nation's economy.

* * *

The current expansion will go down in history as being the one that most confounded the pundits. If you will remember, when it began in the fourth quarter of 1982, most analysts anticipated an "anemic and short-lived" recovery. Despite these predictions, this recovery has turned out to be (so far) the third longest recovery in postwar history. Already having entered its 18th quarter, it is surpassed only by the 1975-1980 expansion, which lasted 20 quarters, and the 1961-1969 episode, which lasted 35 quarters. Moreover, in some sectors of the economy, it has already become the longest postwar expansion. The domestic automobile industry, for instance, reports that the automobile recovery was, as of last month, 59 months long--two months longer than the previous longest car industry expansion. Admittedly, certain other sectors, such as the domestic oil industry, have fared poorly of late. However, it is noted that many of the problems facing the industries that have yet to recover are not related to the general state of the economy but are industry-specific, i.e., the sharp drop in oil prices in the case of the oil and related industries, or structural, for instance, (in the case of the U.S. steel industry.

Even taking account of the relative weakness of the past two years, economic performance measures up well to previous cyclical experience. Real

Gross National Product (GNP) has risen by 17 percent since the beginning of the recovery, compared to an average increase of 20.5 percent during past expansions. But as the table shows, the shortfall was due to the performance of net exports and investment in nonresidential structures while other components of GNP have performed remarkably well. In particular, residential investment has risen by a record-breaking 97 percent, versus an average increase of only 46 percent during past recoveries. Importantly, other indicators of economic health also show a robust economy. Despite all the hand-wringing regarding the so-called "de-industrialization" of America, industrial production has increased by 22.7 percent since the end of the recession, this is comparable to the experience of the 1960s and not significantly below the cyclical average. Similarly, civilian employment has risen by 11 percent, compared to only 6 percent in the 1960s and an average cyclical increase of 10.5 percent. The civilian unemployment rate has declined by three percentage points since the recovery began, versus an average decline of only two percentage points. Finally, the consumer price index has risen by only 12.3 percent, compared to an average increase of almost 19 percent.

An important but often ignored point is the fact that by the end of the second year of recovery (the third quarter of 1984), real GNP had risen by 6.1 percent, almost twice as fast as average. By the third quarter of 1984, investment in nonresidential structures, was also rising faster than average (2.6 percent versus an average of 1.5 percent) and investment in producers' durable equipment had increased 2.2 times faster than average. But the latest data available (1986:3) shows that investment in structures has declined by 7 percent since the bottom of the recession, and equipment investment is now much closer to the average increase. Why did the recovery begin with such strength and then lose its luster? One explanation is fiscal policy. By the end of 1982, the first two installments of the 1981 Economic Recovery Tax Act (ERTA) had been implemented and the economy took off. It was no coincidence that the economy weakened in 1985 and 1986 because, as the table shows, the 1981 tax cut was whittled away to almost nothing by subsequent tax increases.

TABLE 1
Cyclical Experience*
(Percent)

Cycle Trough	GNP	Consumption	Residential Investment	Nonresidential
1960:4	20.5	17.9	23.5	28.7
1975:1	20.4	19.1	63.3	34.4
Average	20.5	18.5	46.4	31.6
1982:3	16.9	19.3	97.0	26.9

Cycle Trough	Producers' Durable Equipment	Nonresidential Structures	Exports	Imports
1960:4	42.0	15.5	30.8	30.5
1975:1	44.5	16.9	30.9	42.3
Average	43.3	16.2	30.9	36.4
1982:3	48.6	-7.0	3.3	53.7

Cycle Trough	Civilian Employment	Industrial Production	Consumer Price Index
1960:4	5.9	22.9	4.7
1975:1	15.1	32.8	31.6
Average	10.5	27.9	18.6
1982:3	10.9	22.7	12.3

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*Increase in real activity during the first 16 quarters of a cyclical upturn.

TABLE 2

What is Left of the Economic Recovery Tax Act of 1981
(FY 1981 - FY 1989)

1981 Tax Cut	-$1,488
1981-86 Tax Increases	
Inflation Induced Bracket Creep	650
Social Security Tax Rate Increase	287
1982 Tax Equity & Fiscal Responsibility Act	311
1983 Gasoline Tax Increase	28
1983 Social Security Amendments	90
1984 Deficit Reduction Act	101
Other	9
Total 1981-86 Tax Increases	+1,476

Source: U.S. Treasury

One final point with regard to the present state of the American economy is the fact that weakness, like beauty, is in the eye of the beholder. Real GNP rose by "only" 2.7 percent in 1985 and 2.6 percent (estimated) in 1986. While this may seem "weak" to some, the fact is that this performance is close to the average increase of the past 26 years (3.1 percent) and better than or even with the experience of many other major industrial countries. Other indicators also belie the notion of weakness. Civilian employment has increased by 4.4 million jobs during the past two years alone (11.1 million jobs have been created since the recovery began), bringing the percentage of the adult population currently employed to a record 60.9 percent. The increase in employment boosted real personal disposable income, which rose by 1.4 percent and 3.2 percent during the past two years, respectively. This increase in income was, in turn, reflected in strong sales performance. Domestic car sales averaged 8.2 million units both years, and new housing starts averaged around 1.79 million units. In contrast to previous expansions, this performance was accompanied by falling inflation and interest rates.

In sum, despite some lingering concerns, it can be said that, overall, the last four 4 years have witnessed the healthiest peacetime economy. It must be remembered that the 1960s expansion incorporates our costly involvement in Vietnam. This leaves us with only the 1975 expansion as an appropriate comparison, and that expansion had the highest rates of inflation this nation has ever known.

* * *

As the economy enters its fifth year of recovery, all signs point to a continuation of moderate rates of economic growth. We anticipate an inflation-adjusted increase in gross national product of three percent this year and 3.2 percent in 1988. Our forecast for this year is more optimistic than the consensus, which anticipates only a 2.4 percent increase in economic activity in 1987, followed by a 3.3 percent improvement in 1988. Although there are policy risks facing the economy, our relative optimism is based on the fact that the usual harbingers of a downturn are nowhere in sight. In particular, the contention that the economy is due for a recession because of the aging of the business cycle is without basis. In this regard, we should remember that, more often than not, periods of expansion die as the result of policy mistakes, not old age.

Historically, periods of economic expansion have ended when the economy reaches the limits of its productive capacity. The signals that presage the end of an expansion are: rising interest rates, inflation, labor costs, and capacity utilization rates. This time, however, capacity utilization in the manufacturing sector remains substantially below the levels at which bottlenecks and supply interruptions would occur. Moreover, rather than increasing as the expansion progresses, as is usually the case, the rate of capacity utilization has been falling during the past two years.

Rising labor costs are another indication that the economy is facing constraints that can push it into recession. But increases in unit labor costs during the past two years have been very modest. This has been an important factor in keeping inflation in check; the price level, as measured by the implicit GNP deflator, has been rising by steadily smaller increments since 1981. Typically rising inflation during the later stages of recovery prompts the monetary authorities to restrain the supply of money, thus choking off the expansion.

Finally, during other expansions, as the economy continued to grow, the increased competition for loanable funds, as well as rising inflationary expectations, put upward pressure on interest rates. Rising interest rates, in turn, depress activitity in the interest-sensitive sectors, such as housing and autos, and that decline feeds through to the rest of the economy. This time, however, not only have interest rates not risen, they have continued to decline.

* * *

The sources of growth in the U.S. economy during the next two years are likely to be quite different than what they have been so far. The investment sector, which led the recovery during its initial phase and posted record-breaking rates of growth, is expected to make the smallest contribution to GNP growth. Although capital spending could make a larger contribution to overall growth, investment is constrained by the impact of tax reform, the effect of which was already felt in 1986. Residential investment is expected to fall by two percent in 1987 and increase by 1.9 percent in 1988. Nonresidential investment is expected to increase to by only 2.1 percent this year and recovers in 1988, rising by 4.3 percent.

Consumer spending, which buoyed economic activity in 1985 and 1986 should continue to support economic growth, although it will not be the leading influence that it has been in the past. Large increases in consumer spending during the last two years have satisfied a significant portion of pent-up demand for durable goods. Moreover, relatively high levels of consumer indebtedness may begin to act as a constraint on discretionary spending. I emphasize, however, that we do not believe that consumer indebtedness, in and of itself, will precipitate a downturn or seriously hamper economic growth. We expect that real consumer spending will rise by 2.5 percent in 1987 and 2.4 percent in 1988.

The mid-1986 surge in consumer spending, accompanied as it was by continued increases in the ratio of installment debt to income and a sharp drop in the personal savings rate, has prompted many analysts to fear that the consumer is no longer in a position to continue supporting the expansion. These arguments are almost identical to those voiced at the end of 1985. During 1985, as is the case now, consumer spending rose faster than the overall economy. In fact, the numbers are remarkably similar: real consumption increased by 3.5 percent in 1985, while gross national product rose by 2.7 percent; estimates for 1986 place the consumer spending increase at 3.9 percent and the increase in GNP at 2.6 percent.

Then, as now, the increase in consumer spending was largely in durable goods consumption, and the bulk of that strength was accounted for by purchases of motor vehicles spurred by dealer incentives and below-market financing. For instance, domestic car sales surged to 9.4 million units during the third quarter of 1985. The story was repeated again in 1986, as domestic car sales reached an annual rate of 9.7 million units during the third quarter, as a result of very low interest rates. Similarly, the ratio of consumer installment debt to disposable income was reaching new heights, and the savings rate had dipped substantially at the end of 1985.

All of these developments are related. The below-market financing offered by auto dealers was a powerful incentive for consumers to buy new cars. As they did so, the savings rate declined and consumer installment credit outstanding surged. The personal savings rate fell by 2.5 percentage points between the second and third quarters of 1985 and then bounced back. The same pattern is being repeated this time around.

The current situation does differ from the 1985 experience, but in ways which tend to reinforce our optimism. On a month-to-month basis, there does not seem to be any discernible pattern in the rate of growth of consumer installment credit outstanding. However, on a twelve-month basis, the rate of increase in consumer credit outstanding has been slowing steadily for the past two years, despite the fact that it remains at double digit levels. Another fact that has not received much attention is that the delinquency rate on consumer installment loans, after reaching a peak in May and June of last year, dropped sharply during the third quarter of and is now at a rate comparable to the lowest reched in 1985. Moreover, the Mortgage Bankers'

Association recently reported that the mortgage delinquency rate had fallen to its lowest level in two-and-a-half years.

Finally, three factors appear to be exaggerating the burden of debt on consumers. First, although the debt burden has increased, so has household net worth. Second, the debt to income ratio exaggerates the burden of debt because of the continued convenience use of credit cards. Surveys show that as many as half of the users of bank credit cards pay their bills in full every month. Some estimates have placed the overstatement on the debt to income ratio resulting from this factor alone at about one percentage point. Third, demographic trends are compatible with the increase in indebtedness that we are now witnessing. The life-cycle theory of consumer behavior holds that younger households borrow heavily to purchase homes and consumer durables. As the proportion of the population in the 25 to 44 age bracket has continued to rise, so has household indebtedness.

These mitigating circumstances of the consumer debt situation are tempered by the fact that the ratio of consumer debt to income has continued to rise, that the delinquency rate on consumer installment credit is significantly above the 1984 lows, and that personal bankruptcy filings have also increased. But at most, the pluses and minuses in the consumer picture should offset each other. We expect consumer spending to continue growing at a healthy pace during the next two years, although we do not anticipate that the spending surges of last year will be repeated.

This leaves inventory investment and net exports as the major contributing factors to economic growth this year and next. Real inventories are expected to rise by $19.6 billion this year and $24.1 billion in 1988. We anticipate that a turnaround in real net exports will result from increases in export growth and a deceleration in import growth. The evidence shows that the impact of currency depreciation does not show up in the trade figures until approximately two years later. For instance, while the dollar began to appreciate in late 1979, net exports did not decline significantly until mid-1982 and net exports did not turn negative until mid-1983. Encouragingly, some industries have already reported important increases in export orders. For example, orders for paperboard have risen by 18.5 pecent, pharmaceuticals orders rose by 14.7 percent, and orders for electrical parts and metalworking machinery have both increased by 13.8 percent.

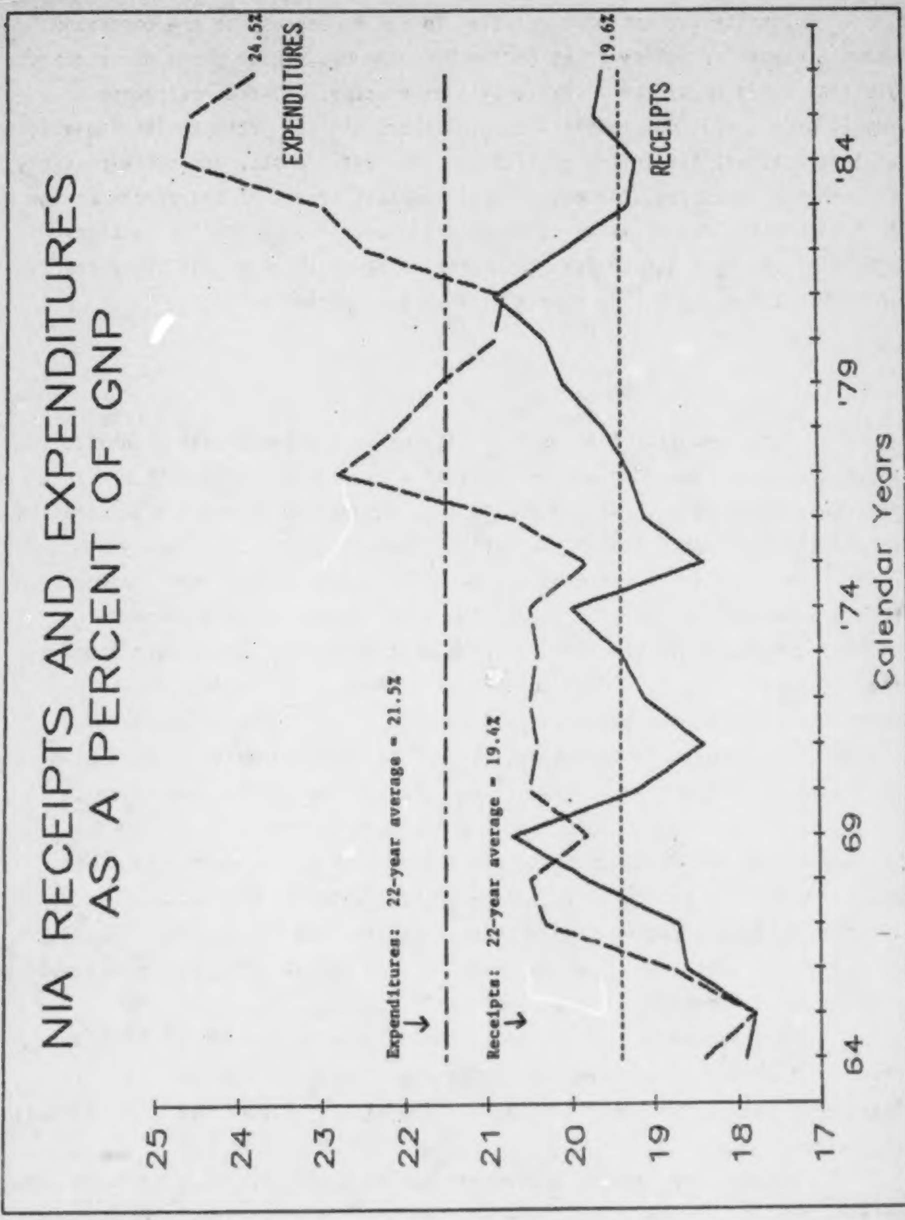
Despite our optimism relative to the consensus, we are concerned about a number of policy risks facing our economy. Chief among our concerns are that (1) a major tax increase will be enacted; (2) the resurgence in export growth will not materialize; (3) short-sighted protectonist legislation will be enacted, triggering retaliation, increased costs, and quite possibly, a worldwide recession; (4) the initial negative impact of tax reform on the business sector may be larger than we anticipate and offset the salutary effect of the cuts in marginal tax rates in the near term; and (5) excessive growth in the money supply supply will trigger higher inflation.

* * *

The chart that follows, one with which you are probably familiar, shows government spending and receipts as a percent of total output during the past twenty-two years. As you can to see, government revenues have remained a relatively constant share of the national output during all these years. Federal receipts (on a National Income and Product Account basis) now account for 19.6 percent of GNP, the twenty-two year average is 19.4 percent. However, beginning in the mid-1970s, we lost control of government spending, and its share of the national output has risen significantly. Federal expenditures (NIA) now stand at 24.5 percent of GNP (using unified budget figures, the comparable percentage is 23.8 percent) compared to an average of 21.5 percent during the past twenty-two years. The gap between these two lines is, of course, the deficit. The increase in the ratio of federal outlays to GNP reflects the fact that spending is rising faster than GNP, while the deficit gap reflects the fact that, with the exception of 1983, spending is rising faster than receipts. These data point clearly to the source of the deficit--excessive spending--and suggest that the cure should be a reduction in spending, not an increase in taxes.

Further reductions in federal spending as a percent of GNP are crucial if we are to achieve rapid economic growth. One thing is clear: failure to control the growth of public spending is associated with economic stagnation.

At very low levels, government spending will increase economic growth because public services that are essential for the market to operate (such as a judicial system or national defense) are provided. However, as government


NIA RECEIPTS AND EXPENDITURES
AS A PERCENT OF GNP
25
24
23
22
21
20
19
18
17
64
69
'74
'79
'84
Calendar Years
Expenditures: 22-year average = 21.5%
Receipts: 22-year average = 19.4%
24.5%
19.6%
EXPENDITURES
RECEIPTS

spending as a proportion of GNP continues to increase, the public goods and services begin to crowd out privately produced goods and services. Additional government programs become less and less efficient in providing net benefits of real value as compared to the private sector. Society's resources become less efficiently utilized and output gains become smaller as citizens are increasingly rewarded for unproductive behavior.

We need only look to Europe to see the evidence of this negative relationship between government spending and economic growth. Indeed, industrial country data for the past twenty years reflects this relationship. Average real GDP growth for the seven major industrial countries has slowed steadily since 1965. Not coincidentally, the government share of GDP has risen just as steadily.

TABLE 3
Government Spending and Growth
Seven Major OECD Countries
(Percent)

	Government Outlays as a % of GDP	GDP Growth Rate
1965-69	32.6%	5.0%
1970-74	33.4	3.6
1975-79	37.4	3.3
1980-84	41.2	1.8

Source: Organization for Economic Cooperation and Development

This does not mean to imply that the increase in government spending is the only reason that economic growth slowed. Obviously, other factors such as increased energy prices in the 1970s and the world recession in the early 1980s affected these economies. But Europe's continued deterioration after the vigorous recoveries of the less heavily taxed U.S. and East Asian economies suggests that the primary problem is government absorption of rescources. Preliminary analysis indicates that in the OECD countries maximum rates of economic growth occur when government spending is about 15 to 25 percent of GNP and the slowest rates of economic growth occur when government spending exceeds 45 percent of GNP. Moreover, a recent cross sectional study of 30 countries by Barth, Keleher and Russek (July 1986), on the link between the size of government and economic growth shows a negative relationship in 27 cases, with 17 of those statistically significant.

As long as the budget process continues to ignore the dynamic effects of tax increases, the solution to the deficit problem will elude us. Tax increases reduce economic activity. The lower levels of economic activity mean lower levels of income (both personal and corporate), and this, in turn, leads to lower tax receipts (and higher expenditures in the form of social insurance benefits). This year, some have already proposed that the full implementation of the marginal rate reductions, which are to take effect in 1988, be delayed. Such a delay would have a serious negative impact on the economy. We know from the experience of ERTA that delaying the tax rate cuts depresses economic activity until the reduction is fully implemented. Moreover, the 1987 transitional rate structure is not low enough to compensate for the economically damaging changes in the tax base, such as the repeal of the investment tax credit, scaled back capital cost recovery allowances, and reduced capital gains exclusions. Tax reform's lower 1988 personal and corporate tax rates mitigate the adverse impact of these changes. However, if the higher 1987 transitional rate structure is retained, business investment, economic growth, and our international competitiveness will remain a problem.

Some have justified this delay by arguing that it would fall most heavily on the well-to-do. But under tax reform, the wealthy receive a dramatically smaller tax cut than the middle class and the poor. Tax reform imposes a stiff individual minimum tax, eliminates most tax shelters, and raises the top capital gains tax rate. Many upper-income taxpayers with heavily sheltered income will be hit with massive tax increases. Moreover, the empirical evidence tells us that marginal tax rate reductions actually raise the share of the total tax burden borne by the wealthy by luring them out of tax-sheltered investments and reducing the tax disincentive to work, save, and invest. ERTA reduced the top tax rates for the rich from 70 percent to 50 percent, but those earning more than $1 million paid 37 percent more taxes in 1982, a recession year, than in 1981. By 1984, they paid 210 percent more taxes. Top tax rate reductions during the Kennedy Administration and in the 1920s had similar distributional effects.

* * *

Although we anticipate a turnaround in the trade figures during the next two years, we believe that lack of improvement in this area is an important threat to the economy. One major problem in the trade area is the fact that economic growth in our trading partners has been low and the prospects are not encouraging. According to the Organization for Economic Cooperation and Development (OECD), the European economies are expected to grow by only 2.5 percent this year, and the Japanese economy is projected to grow by 2.8 percent. The pattern is expected to continue during the first half of 1988. According to the International Monetary Fund (IMF), economic growth in the developing countries should reach only 2.9 percent this year. The IMF anticipates that the volume of world trade will grow by 3.8 percent this year, down from last year's estimated 4.3 percent improvement. Given the lackluster performance anticipated for the next two years in the economies of our trading partners, it is difficult to see from where the increase in demand for American goods will come.

Nevertheless, the impact of the dollar's depreciation on U.S. exports and imports should begin to be felt in 1987 (two years after the depreciation began, as estimates of the J-curve delay show). But the extent to which the improved competitiveness of U.S. exports, due to a depreciated dollar, leads to an increase in exports depends on whether or not there is a recovery in the world economy, particularly in Europe and Japan. If those economies remain weak, the U.S. trade deficit will remain wide and the world economy will be in jeopardy. A strengthening in economic activity in Western Europe and Japan is important not only because that will increase their demand for American goods and services, but because it will increase their demand for developing country exports as well. This would have two positive effects: first, it would imporve these countries' ability to service their debt and alleviate the risk to the international financial community of a major debtor default; and second, to the extent that an increase in developing country exports to Western Europe and Japan strengthens the LDC economies, it will also strengthen LDC demand for American goods. This is a very important point since the LDCs are a significant source of demand for American goods, and a large portion of our tarde deficit can be traced to the problems faced by those economies.

However, the future of America's export industries is not in the hands of European and Japanese politicians, but in our own. While the buzzword in Washington these days is international "competitiveness," many of the tax policy changes that were made as part of the Tax Reform Act of 1986 will work to the detriment of our international competitiveness.

For example, the Tax Reform Act raised the capital gains tax rates for individuals and corporations. Through its impact on risk investment and mobility of capital, higher capital gains tax rates on individuals and corporatins will negatively affect innovation, technological advancement, and new business formation. American firms will find themselves at a special disadvantage vis-a-vis competitors from Japan, West Germany, and South Korea, whose citizens are exempt from capital gains taxes. The Tax Reform Act repealed the Investment Tax Credit and reduced depreciation deductions for investment in plant and equipment. These changes raise the cost of capital and increase the tax bias against investment. Lower levels of investment mean lower productivity and, thus, higher costs for American products. The new corporate minimum tax treats a large portion of accelerated depreciation as a tax preference item. This effectively repeals the bulk of any economic development or international competitiveness benefits accruing to the U.S. economy as a result of the capital cost recovery system. A national commitment to research and development (R&D) is critical to the maintenance of America's technological advantage in international competition. The Tax Reform Act reduced the R&D tax credit rate from 25 percent to 20 percent and failed to make it permanent. The Tax Reform Act's separate foreign tax credit limitation and allocation provisions will raise taxes on the worldwide operations of U.S. firms. This tax increase will work to offset the reduction in the U.S. corporate tax rate.

* * *

It is clear to us that the 100th Congress will pass trade legislation. We think there is great potential for constructive changes in this regard, and we intend to work closely with the Congress. Nonetheless, protectionist legislation represents another policy risk to the U.S. economic outlook. Protectionism is not only the wrong solution to the trade deficit but also a dangerous and irresponsible reaction to the problems of the export sector. We must not forget the lessons of the 1930s and enact another Smoot-Hawley debacle. Protecionism enoucrages retaliation and trade wars. Protecionism _vis-a-vis_ the indebetd developing countries will impair their ability to increase exports, raise foreign exchange and repay their debts, threatening the international financial system. Protectionism increases domestic costs of imported inputs and consumer goods, further exacerbating inflationary pressures. The solution to the trade conundrum is (1) to encourage our industrialized trading partners to increase their own domestic demand; (2) to work to reduce nontariff trade barriers which unfairly keep U.S. products out of certain markets; and (3) improve the competitiveness of U.S. exports by enacting legislation that will reduce the cost of capital in the United States and enhance the international competitiveness of our industries.

* * *

While we applaud the reduction in marginal tax rates on individuals and corporations, which were the centerpice of the Tax Reform Act, the many offsetting tax increases on businesses will have a decidedly negative impact in the short run. In fact, tax reform wreaked havoc on the investment sector even before it was enacted. The debate over the alternative bills increased uncertainty, and contributed to a decline in investment in 1988, following several years of significant gains. Were it not for the effects of tax reform, the investment sector could be expected to play a more important role in supporting economic activity in 1987.

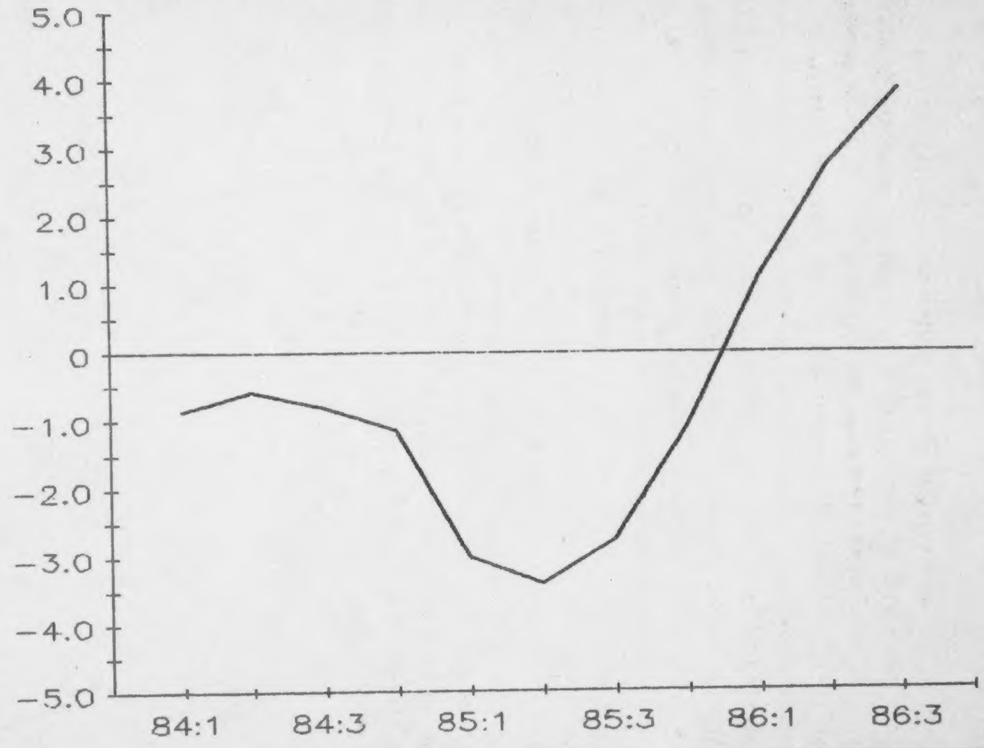
The new tax treatment of capital gains is particularly troublesome. The new law raises the maximum capital gains tax rate from 20 to 28 percent. Increases in the capital gains tax will have adverse economic effects. They will reduce the willingness of venture capitalists to take risks in innovation and technological advancement and consequently have a negative impact on the ability of small businesses to raise equity capital. Higher capital gains rates reduce the liquidity and efficiency of capital markets. Moreover, they reduce taxpayers' desire to realize capital gains, thus reducing tax revenues (there is nothing to tax if the capital gains are not realized). The U.S. government actually gained revenue from the capital gains tax reductions in 1978 and 1981. This flaw could be repaired easily either by reducing the capital gains tax rate or, at the very least, by reducing the amount of taxable capital gains to the extent that the gains are purely inflationary.

What is the overall net impact of the Tax Reform Act on the cost-of-capital and business investment? The reduction in personal and corporate tax rates tends to reduce overall cost-of-capital. But the increase in the capital gains tax, the imposition of a stiff corporate minimum tax, the repeal of the Investment Tax Credit, and the reduced depreciation allowances tend to increase the overall cost-of-capital. On balance, business fixed investment will fall in the long run because economic resources will flow into productive investment, labor costs will fall dramatically, and interest rates will decline as more funds are channeled into savings instruments. But the U.S. tax system can be further improved by moving toward expensing of capital investment, abolishing the capital gains tax, integrating the corporate income tax with the personal income tax and moving toward lower rates.

* * *

The potential for increased inflation is another risk to our economic well-being. Despite the fact that wage pressures remain moderate, the risks of a resurgence in inflation have recently increased. Although the relationship between the rate of growth in the money supply (as measured by M1) and nominal GNP is not the same now as it was in the past, the rates of increase in M1 that we have recently experienced are still alarming. For instance, M1 rose by 16.3 percent during 1986, and between the end of October and the end of December it increased by 25.3 percent. Given the fact that

IMPLICIT DEFLATOR FOR NONOIL IMPORTS
(Percent Change, Year Ago)



nonoil import prices are rising steadily as a result of the dollar's depreciation, and oil prices have also risen, the prospect for a reacceleration in inflation have increased.

* * *

This recovery, which began with above-average strength, was debunked almost every step of the way. First, it was not supposed to happen. Once it was clear that it was underway, we were told that it would be weak and not last long. And now, its impending death is reported frequently. Despite this cynicism, however, the economy has continued to move forward and, if the majority of the forecasting profession can be believed, it is on its way to achieving record longevity. Admittedly, everything is not coming up roses, some traditional industries have not recovered and are not likely to, the energy sector is depressed, and there are regions which have not fully recovered. Despite the impressive increases in employment, the unemployment rate is not as low as we would like and interest rates could also be lower. These are causes for concern and we look forward to working together with this Congress to develop policy to address them. But we should remember that what we have done in this decade, in sharp contrast to the previous one, is that we have added a sense of stability and certainty to the economy. Compare that to the extreme ups and downs, high inflation, and high interest rates of the previous decade.

Senator SARBANES. Well, thank you very much. I think we'll limit ourselves to 10 minutes for each member for questions and then have a second round.

Mr. Rahn, I was struck by one comment you made and I want to inquire about it at the beginning. You said that the stock market is as good a forecaster as the professional economist. I'd like you to elaborate on that statement.

Mr. RAHN. Well, I think if you go back through the forecasting record you'll find that our crystal balls have not been all that clear over the years. There are certain things economists do know and certain things we don't know. We can, I think, discuss the effects of certain policy changes with a high degree of confidence.

But, in terms of seeing the future, there are too many unknown variables. Let me just give you one example: Oil prices. My own feeling is that current oil prices, now in the $17-$19 per barrel range, will probably drop back somewhat in the spring. The reasoning behind this forecast is that if you look at worldwide production capacity versus demand, you find that demand is only about 60 percent of production capacity.

The OPEC oil producers have an enormous incentive to cheat and produce more than the quota allotted at their last meeting. I think that we will see the agreement break down as we've had in the past.

Now that is not a scientifically based forecast. It's my observation of history. If I am wrong on that, if, suddenly, we had a big surge in oil prices, clearly, we would have much higher rates of inflation. If I'm right on that, even with the high monetary growth and a decline in the U.S. dollar, we can avoid a big pickup in inflation for a while.

But those kind of analyses go well beyond what we can do scientifically. We make certain judgments about what's going to happen with the Iraqi-Iranian war, but this is not going to have a major impact on worldwide oil supplies. Of course, if the war gets much more heated, it could have a big effect. And that's just one example of why I think the professional economist has had such a hard time forecasting the future with great precision.

People who invest in the stock market look at much the same data that Mr. Chimerine and I do. And they come to their own conclusions.

I think that the economics profession is far behind where the physicians, physicists, and others are in terms of scientific advancement.

Senator SARBANES. Well, you made a double statement, and that's what I want to get at. I understand you're putting yourself and your colleagues down in terms of the degree of respect that your forecasts ought to be accorded——

Mr. RAHN. I think the——

Senator SARBANES. But I'm not quite clear why you are elevating the stock market as a better forecaster of how the economy is going to go. What is that based on?

Mr. RAHN. While I don't have the latest data handy, I remember that from past experience that changes in the stock market are a good indicator of future economic activity.

I'm not trying to put down the economics professional. I am saying that there are certain things at which economists are very good. And you ought to pay a great deal of attention to us. But, looking at the future is not something that any human can do with great accuracy.

Senator **Sarbanes**. Well, let me ask both of you to take a somewhat longer view of the future. The administration's budget forecast is that we'll balance the Federal budget by 1992. As I understand it, that's based on certain long-range economic forecasting on their part, including a number of assumptions. I want to ask each of you about the reasonableness of these assumptions, including the reasonableness of assuming that all of them will happen, since the forecast is premised on the assumption that all of the following developments will in fact occur:

No recessions before the end of 1992. Growth averaging 3.5 percent over the period 1987 to 1992. A steady decline in the unemployment rate to 5.5 percent. A steady decline in interest rates—for instance, the rate on 10-year Treasury notes would decline from 7.7 percent in 1986 to 4.5 percent in 1992. And inflation, after rising in 1987 from the very low level of 1986, decreasing steadily to 2 percent.

So I repeat the question: What is the probability of all of these developments occurring simultaneously over the next 5 to 6 years?

Mr. **Chimerine**. I would answer that, Mr. Chairman, in two words: Extremely unlikely. I'd give it an almost infinitesimal probability of occurring, particularly on the growth side. I think that the chances of having 3.5 percent average growth for the next 5 years are so small that it essentially can be dismissed.

Senator **Sarbanes**. Mr. Rahn.

Mr. **Rahn**. I would have to largely agree that these things would occur. But while I think it is possible, I don't think it's terribly likely. We have to realize that over the last 6 years, the Congress has overspent their own first budget resolution by an average of $28 billion a year.

We need to see more fiscal discipline on the part of the Congress and the administration if we're going to get close to a balanced budget.

And, finally, I should add that a balanced budget is not absolutely necessary. What we need, in my judgment, are budget deficits of sufficently small magnitudes so that the interest portion of the debt is a falling percentage of GNP rather than the rising percentage it is now. If we achieve that, we're basically out of the woods on it.

Senator **Sarbanes**. Do you think that the targets contained in Gramm-Rudman for the deficit, the numbers for the deficit, have any particular validity—aside from the goal of reducing the deficits and particularly getting it into the range, Mr. Rahn, that you just talked about, so that the problem is diminishing rather than expanding?

Do you regard the specific numbers in Gramm-Rudman in terms of the year-to-year goals for the budget deficit as having any particular validity?

Mr. **Rahn**. It has a certain psychological effect but not an economic one. I think the important thing is to show substantial progress on the deficit, in a credible way, year to year.

I look at the kind of progress you've made this past year as a great step forward which should be continued. Even though you may miss the targets by a reasonable number (I don't know if I want to define "reasonable"), so that the financial markets are confident that Congress is serious about getting the problem under control, that would be sufficient.

Mr. **Chimerine**. Mr. Chairman, I would—I guess I agree. I think the specific numbers, quite the opposite, in fact, are dangerous. I think, realistically—that is, using realistic assumptions and eliminating the accounting gimmicks and underestimates and all of that, if you really tried to hit the Gramm-Rudman target of $108 billion for fiscal 1988, we'd have a recession over the next 6 to 12 months, or perhaps in 1988.

In my judgment, what you really should be trying to do, is to reduce the deficit year by year by somewhere in the range of $25–$30 billion a year. If you go down $40 or $50 billion, you're really taking a big bite out of the economy too quickly.

Therefore, somewhere around $75–$100 billion is a reasonable target for the deficit by 1992. It would stabilize the Federal debt to GNP ratio, and stabilize the interest part of the budget.

And that should be your target 5 years from now. And to get there, you need $25–$30 billion a year in deficit reduction.

There is another point I would make about Gramm-Rudman, and I think it's very disturbing—we may be cutting programs that we really shouldn't be cutting just to achieve the target.

And, you know, if we do have competitive problems, and if we do have problems with job training and infrastructure, and so forth, and education—which I think is part of our trade and competitive problems—we've got to start addressing those at the same time we cut the overall deficit, it means, first, we're going to have to cut other programs, especially the entitlement program.

And, second, I feel strongly that, eventually, we're going to need some revenue increases. Unless my arithmetic is wrong, and I don't think it is, some revenue increases are going to be necessary to reduce the deficits even to the target level that I describe.

Senator **Sarbanes**. My time is up. I'll come back to this on the second round. Congressman Wylie.

Representative **Wylie**. Thank you, Mr. Chairman. You'll pardon me if I observe that you economists I've heard this morning have had a differing opinion on the state of our economy.

And it seems to me as if that's one of the problems of forecasting here. And that maybe the stock market is as good an indicator as any as to our economic situation.

I would like to have your views as to the impact, what the significance of the recent world market is as far as the state of our economy is concerned.

Mr. **Chimerine**. Well, I'll give you my view. Stocks are heavily concentrated in the upper middle-income groups. Most of these people don't go out and spend more because the market's doing better.

Most people can't even get access to these funds. They're tied up in their pension accounts, or whatever.

So, barring a psychological effect, I don't see any real direct impact from the boom in the stock market on the economy.

Every study that I'm aware of shows that across the wide spectrum of the economy, concerns about job security far dominate the stock market as a factor affecting the way people feel.

And I detect an increasing concern in the economy among people. They see their neighbors being laid off, and IBM is cutting jobs and so are General Motors, and AT&T and other companies.

Under these conditions, I doubt if the average individual is being affected either directly or indirectly by the boom in the stock market.

Representative WYLIE. You said barring psychological effect. I don't really think that we can bar psychological effect. It may be that——

Mr. CHIMERINE. I just concluded that I don't think that's all that significant now either. But, admittedly, that's harder to measure.

Representative WYLIE. The economy may be based in large part on psychological effect and confidence in the administration.

Mr. CHIMERINE. I don't think you can spend psychology, Mr. Congressman. And people who don't have income can't spend.

Representative WYLIE. The inflation rate has gone down. Interest rates have gone down. Employment rate is up. The stock market's up. Corporate profits are up. Oil prices are down.

These are all part of the so-called economic indicators. And they're all positives.

Mr. CHIMERINE. Some are positive, some are not.

Representative WYLIE. They lead you to a pessimistic view as to the state of the economy. So I said, well, maybe it's the psychological end.

Mr. CHIMERINE. Well, Congressman, I don't think my view is pessimistic. I think it is realistic. It indicates that the economy is mixed, it's not tremendously bouyant. I'm not arguing we're in a recession or depression or that we're real bad off.

Representative WYLIE. I don't think we're in a recession or we're going——

Mr. CHIMERINE. But I just don't think the economy is anywhere near as healthly, quite frankly, as the administration has consistently portrayed.

Mr. RAHN. May I make a response to that, sir?

Representative WYLIE. Sure.

Mr. RAHN. I just think this notion that a rising stock market is bad news is absolute nonsense. You have to assume that people who invest in the stock market are irrational to conclude that.

I'd also like to comment on the point that some big firms are laying off workers. This is always true. You have some firms that are moving ahead and some that are declining.

We've had tremendous job growth in this country for quite some time. And, yes, certain firms and certain industries have experienced declines in employment, but many more have increases in their employment.

The fundamental fact is that real after tax wages are now rising. And that we have the highest percentage of our adult work force employed than at any other time in our Nation's history. Anecdotal evidence from a few firms is not a substitute for these macroeconomic facts.

Mr. CHIMERINE. Can I comment on that without taking up your time, Mr. Congressman?

First of all, there's no question that there has been significant job growth in recent years, although, quite frankly, the rate of job increase in the last 6 years has lagged behind what it was during the previous administrative.

Second, I think the evidence is pretty clear that a large fraction of the jobs that have been recently created were in relatively low wage, low productivity occupations and industries, and a relatively large fraction of the jobs we're losing have had higher than average wages.

So there is clearly a shift in the job mix more dramatic than we've ever had before.

And, finally, now that the dollar is falling and import prices are starting to rise, and the decline in oil prices is over, inflation is accelerating, so real wages are stagnating.

That process will continue and be a limiting factor on consumer spending. And, for most people, that's far more significant than what happens to the stock market.

I didn't say the rise in the stock market is bad news. I said, to some extent, it reflects the decline in interest rates and the pumping up of liquidity that isn't going into other sectors of the economy. I didn't say it's bad news. I'm saying, in part, it reflects the absence of strength elsewhere.

Representative WYLIE. Well, who would have ever thought 8 years ago that our interest rate would be 8.5 percent on home mortgages today and that the inflation rate would be somewhere between 2 and 3 percent, and that last year, we sold $400 billion in home mortgages, which is an alltime high? How do you explain those figures?

Mr. CHIMERINE. Well, I remember back 15 years ago when housing starts used to be 2.2 million a year. Now we brag when they're 1.7–1.8 million a year. I don't view that as outstanding. But it is better than it was 4 or 5 years ago. And, in terms of interest rates, I don't know a lot of farmers who think interest rates are low. Nor many manufacturing companies.

There is still a large segment of the economy which cannot make money at current levels of interest rates because rates relative to the prices of the products they produce, are still extremely high.

Representative WYLIE. My constituents feel like the most serious problem facing the country right now is the budget deficit, with the possible exception of congressional pay raises. I'm getting more mail on that than anything else right now. [Laughter.]

Senator SYMMS. Don't they realize your value, Chalmers?

Representative WYLIE. I guess not. [Laughter.]

But, in any event, you talked briefly about the Federal budget deficit. You indicated, I think, some modification in Gramm-Rudman-Hollings, but at the same time indicated that you felt like the deficit was too high and should be brought down.

Mr. CHIMERINE. Absolutely.

Representative WYLIE. You feel that way, too, as I understand it.

Mr. **Rahn**. What?

Representative **Wylie**. The budget deficit is too high and needs to be brought under control.

Mr. **Rahn**. Yes. And I disagree with my colleague. Hitting the Gramm-Rudman target would be, in my judgment, to the Nation's advantage, it would not cause a recession. I think it's ludicrous to argue that hitting Gramm-Rudman would cause a recession.

Representative **Wylie**. How would we go about bringing down the budget deficit under your scenario?

Mr. **Chimerine**. I think it has to be done as part of an overall assessment of our priorities, including what we have to do to improve our competitiveness in world markets. This might include putting some money into our educational system, into job training, and whatever other programs we find are important.

Second, a full assessment of our military expenditures is in order—can we make additional cuts without harming national security?

Third, are we willing to bite the bullet on some of the entitlement programs.

And then what's left over after all that is added up and subtracted, we have to get on the revenue side. It's that simple.

And the idea that we can get to a balanced budget in 1991, or anywhere near it, without any revenue increases is absolutely absurd. It is almost mathematically impossible without dismantling large numbers of programs that I don't think the people in this country want dismantled.

Representative **Wylie**. Well, my time is up but I wonder if we can affect any improvement in the accuracy of economic forecasting of economists in the near future.

Mr. **Chimerine**. Well, I've testified at this committee many times in recent years, Congressman, and you're welcome to look back at the record. And I think, if you do, it hasn't been quite so bad.

Representative **Wylie**. Thank you. Thank you, Mr. Chairman.

Senator **Sarbanes**. Thank you. I'd like to just interject some information here from the Blue Chip forecast. I will just read a statement from the Blue Chip piece, "the consensus forecast for 1987 economic growth by our panel of more than 50 top economists was shaded downward again to a sluggish year over year advance of just 2.4 percent."

This is in contrast to the assumption of 3.1 percent growth that was projected by OMB in the budget.

Then the Blue Chip piece notes the range of the forecasts. The top 10, the optimistic top 10 projected 3.6 percent growth, which was of course even higher than OMB. And the bottom 10, projected 1 percent growth.

So you had a range among these forecasters of 1 to 3.6 percent, which is quite a wide range, with the OMB forecast very close to the top of that range. I think one of the purposes here is to get some sense of this range of forecasts as we look at the assumptions that underlie the Economic Report and the policy projections that are made on the basis of that forecast. Senator Melcher.

Senator **Melcher**. The statement you made, Mr. Rahn, regarding the stock market surge being a good indication of investor confidence, perhaps as accurate as economists, if that were taken literally, some people might think that we don't need economists. We need to just call up a stock broker and say "What's your attitude?"

But I think I follow your real line of thought on looking backward comparing the predictions of the economists on a certain period of time, over a certain period of time, as compared to stock market strength being about as accurate as the economists were.

Well, I wonder if it isn't a phenomena that we're experiencing right now with the stock market with lower interest rates for individuals seeking to do something with their CD's or rather than certificates of deposits, they're shifting money into the stocks and pension funds, looking at what they can get in interest rates, they're shifting sizable chunks of their holdings into stocks.

Isn't that quite likely to be occurring rather than strong feeling of growth?

Mr. **Rahn**. There are certain risk premiums that investors are willing to take.

Usually, in the case of retirement funds, the risk premiums are lower than for certain other types of investments.

Once you net out the risk premiums, investments will take place in the area which gives the highest rate of return.

I think that going into the stock market is desirable because it enables companies to raise equity capital and invest in real plant and equipment if they so desire. When you have a very depressed market, it is extremely hard for them to do that.

Sure, there's been some shifting. The stock market is relatively more attractive now than some types of rental housing. For certain higher tech or service industries, the stock market will be relatively more attractive than housing and some other investments because of the tax law changes enacted this past year.

But that alone doesn't explain the very large surge in activity. While I don't claim that there is a one-to-one relationship between the stock market and real economic growth, the direction of stock market changes is important to the future direction of the economy.

Moreover, you don't get this kind of very rapid and sustained rise in the stock market if investors didn't believe that rates of return are improving or that business opportunities are good.

Senator **Melcher**. Well, it isn't based on profitability, certainly. And whatever the cause of the phenomena, I guess I'll be an interested spectator.

But, Mr. Rahn, I referred in my opening remarks to some reaction on or effect on inflation, since the basic commodity prices both in agriculture and energy are low.

There will be an effort within the United States to develop policies that will probably increase exports. And, in doing so, will probably raise the prices of some agriculture commodities.

I suspect—you didn't comment on that, but I'll ask you to comment on it in a moment. We make policy here in the Congress and sometimes it's evident. For the last several years, eight of us in the Senate, in the Northwest, were determined that something be done about the Canadian lumber coming into the United States.

Without getting into the why they do it or how they do it, there is a difference in pricing of logs in Canada as compared to the United States. Because they had gained about 34 percent of the domestic softwood market, a block of eight of us, six Republicans and two Democrats, were determined that policy had to shift, hopefully, voluntarily on the part of Canada.

That went on for several years before other Senators in other parts of the country realized that what we were after would be advantageous to them. The Trade Ambassador was in negotiations with Canada and effectively placed a—I believe it's voluntary—higher tax on Canadian production and we'll probably see a slight decline in Canada's percentage of our softwood market.

So we gained our purpose. Let's see how it works. There's probably 20 of us here in the Senate that are determined that through using a variety of agricultural law that is available to the administration, that agricultural exports will pick up this year, particularly in wheat, corn, soybeans.

What effect—how do you measure that then? If exports pick up, surpluses—U.S. surpluses—decline. After all, we're willing to, whatever the price is that we sell corn or wheat at, soybeans, virtually dictates the world price in those commodities.

Do you view that—I'd like your reaction. Do you view that as positive? Do you know if it might have some inflationary effect?

Mr. RAHN. We have the same problem in agricultural exports as we do in other export areas: we need buyers. Who's going to buy from us now? Historically, we had had the Soviets, the PRC, India, and a few other places.

Senator MELCHER. Well, there's about 70 developing countries that we have relations with, longstanding, that we donate surplus commodities to.

Mr. RAHN. We can donate to a number of the African countries. But, the problem is that there are virtually no buyers with money, any more. A number of countries which had been major agricultural importers in the past no longer are. The Green Revolution has taken over. They've become largely self-sufficient.

And then you look around the world. There are all too many countries that have mammoth agricultural subsidies and are producing huge surpluses.

I look at the European common market and given their latitude, they surely ought not to be dumping wheat on the world market as they are, and many other types of commodities.

But, if you just take a look at the worldwide supply and demand—I understood, last year, the world produced enough food for something like 7.5 billion people and there are only 5 billion people in the world.

That means most of the food will end up being dumped or rotting away, or fed to animals, or some such. And even if we found ways to subsidize our prices, if other countries, like the European common market, are going to come up with equal subsidies, we don't gain anything.

The fact is that there are too many farmers and too much production around the world. And I would hope that our agricultural policies would work toward reducing the number of suppliers and perhaps subsidizing the farmers to provide an adequate transition into another type of business, decoupling support of income and increased production.

That clearly has been counterproductive. You mentioned the Canadian lumber situation, here we had a problem where the Canadians had much lower stumpage fees than we have in the United States.

Essentially, they were giving away their timber, or assuming there was no cost of growing it. There are no simple solutions to this. Back when I used to teach international economics, we all had these nice free trade models where we assumed that there were private producers worldwide, and that no private producer would operate at a loss for long periods of time.

The problem is that where you have State intervention, even in capitalist economies like Canada, the State is selling the resources off their land, costs have nothing to do with it and they can run losses forever.

Economists don't have good models for dealing with this. But, when we look at it from a national economic standpoint, yes, if we permit the Canadians to sell lumber at low cost into the United States, some of our businesses suffer. Those workers, the cutters and the people in the mills, lose jobs.

But, if the price of lumber soars in the United States, how many carpenters lose their jobs? And people who would otherwise be able to get homes who can't get homes?

These are difficult questions. You have to look at the tradeoffs before you enact any kind of protectionist or restrictive legislation. And I think you have to take a look at the tradeoffs very, very carefully; look at the possibility of retaliation. What happens when you restrict shoe imports into the United States? The price of shoes goes from $15 to $40. I don't think American consumers are going to be happy with that.

Senator **Melcher**. My time is up. I will get back to you in the next round.

Senator **Sarbanes**. Senator D'Amato.

Senator **D'Amato**. Thank you, Mr. Chairman. Mr. Chairman, I, as most of our Members, have conflicting meetings, and I have another meeting for which I am already a half hour late. So I would ask permission to submit an opening statement in its entirety and to pose just one question.

Senator **Sarbanes**. The statement will certainly be included.

[The written opening statement of Senator D'Amato follows:]

WRITTEN OPENING STATEMENT OF SENATOR D'AMATO

MR. CHAIRMAN, I WANT TO WELCOME TO THE JOINT ECONOMIC COMMITTEE THIS MORNING OUR DISTINGUISHED PANEL OF WITNESSES WHO WILL SHARE WITH US THEIR OPINIONS ON THE ECONOMIC OUTLOOK FOR 1987. AS THE CONGRESS WORKS TO REDUCE THE FEDERAL BUDGET DEFICIT AND THE UNPRECEDENTED TRADE DEFICIT, I, FOR ONE, WELCOME YOUR VIEWPOINTS.

DURING THE PAST FOUR YEARS WE HAVE SEEN THE PRIME RATE REDUCED TO 7.5 PERCENT, THE DISCOUNT RATE LOWERED TO 5.5 PERCENT, AND MORTGAGE RATES BELOW 10 PERCENT. IN ADDITION, IN 1986 THE AMERICAN CONSUMER BENEFITED FROM THE HUGE DROP IN OIL PRICES AND THE FREQUENT RECORDS SET ON WALL STREET. YESTERDAY THE U.S. DEPARTMENT OF LABOR REPORTED THAT CONSUMER PRICES ROSE A MERE 1.1 PERCENT LAST YEAR -- THE SMALLEST INCREASE IN PRICES FOR GOODS AND SERVICES IN 25 YEARS.

YET, DESPITE THESE IMPRESSIVE STATISTICS, THE FEDERAL BUDGET DEFICIT AND THE U.S. TRADE DEFICIT CONTINUE TO SPIRAL. THIS PAST NOVEMBER THE TRADE DEFICIT ROSE TO AN UNPRECEDENTED $19.2 BILLION AND IT IS ESTIMATED THAT THE ANNUAL TRADE DEFICIT FOR 1986 WILL EXCEED $175 BILLION. THIS IS NOT GOOD NEWS FOR A COUNTRY WHICH IS QUESTIONING ITS ABILITY TO COMPETE IN AN INCREASINGLY COMPETITIVE WORLD.

I HAVE DIFFICULTY RECONCILING THESE TWO CONFLICTING TRENDS -- LOW INTEREST RATES VERSUS HUGE DEFICITS. I LOOK FORWARD TO HEARING THE TESTIMONY FROM OUR WITNESSES AND I HOPE THAT THEY CAN PROVIDE SOME INSIGHTS ON HOW WE CAN RESOLVE THIS DILEMMA.

THANK YOU, MR. CHAIRMAN.

Senator D'AMATO. Thank you, Mr. Chairman. I am very much concerned about, and I am wondering if you gentlemen would reflect on, the issue of the Third World debt.

My colleague, Senator Melcher, raises the issue of the sale of food to some of the Third World nations and several developing nations.

I look at the debt as accumulative worldwide of these Third World nations and then the debt that is due and owed to this country, and you see ever-increasing signs of some in Central and South America who are coming together to say, well, you know, maybe we are not going to even acknowledge this.

Gentlemen, how do you factor that in? What are the ramifications if that debt is just not paid back or not acknowledged and the interest on the debt? What takes place?

Mr. CHIMERINE. Well, Senator, let me first very quickly agree with you that it is a key factor in the economic situation now, and as Mr. Rahn pointed out, and I did earlier, it is one of the things limiting the growth of U.S. exports and making it more difficult for economic growth to accelerate in the United States. I think it is part of an overall debt problem.

I mean, we have increased debt throughout the system in the last several years just to keep whatever modest recovery that we have had going. I include corporate debt in the United States, the Federal debt, personal debt, foreign debt, et cetera. It is a little scary because there is a limit to how far you can do this, and you wonder what is going to happen when everybody is overloaded with debt and we can't continue the process. But we have seen that already on the LDC debt.

I think it is a risk. I am not highly concerned about it, though, because I think as long as the Federal Reserve reacts to that by maintaining liquidity in the system, and as long as something is done to relieve the impact on the banking system, I think we can probably handle it.

But certainly, you know, it is a risky situation, and if everybody stops paying back debts or stops servicing the debt, and the banks start writing off more loan, and it restricts their ability to make new loans, it could have an adverse effect on the economy.

But I think the key point is the Federal Reserve can control that, and my own feeling is that is something that could be managed.

But I do agree with you. It does limit economic growth in the United States, and it just continues this sort of very sluggish environment in the entire world economy.

Mr. RAHN. I agree with Mr. Chimerine on that, but I think we have to reflect back to 1982. The situation was really worse then than it is now. The banks are in a better position. Most of them have strengthened their capital base over the past 4 or 5 years.

Senator D'AMATO. Doctor, if I might interrupt you and say, supposing I would characterize our efforts in the refinancing that we have seen every year now as nothing more than a charade, a little game, as, you know, we won't call it due, we are not going to put any—and we will extend it, just get everybody to come in and pump in a little more money and this just keeps growing and growing and growing.

Mr. RAHN. That is right.

Senator D'AMATO. Does that trouble you that at some point that charade won't continue, whether it concerns Mexico or someone else? They all come together and say——

Mr. RAHM. Well, the question is the charade—I think we all realize there is some charade going on, but are we working our way out of the problem even by doing some of the charade business?

My view is that we are slowly working our way out of the problem in terms of the impact on the creditors. I don't think the banks or anybody else I know are under any illusion that they are going to get 100 percent back on these dollars when you look at principal and interest.

But it is sort of like if you made loans to a private party here in the United States and the person couldn't pay and you keep extending it and adding some of the interest to principal and you do that over a period of time and you get a little bit back. At the same time you are strengthening your own financial situation, which most of the banks are, so eventually it becomes less and less important to you, and I think that is the way we are working the way out.

And maybe if everything was perfect in the world, we shouldn't have the charade, but it is necessary for, I think, a lot of political and national pride reasons and maybe a certain accounting is the way we force our banks to account for it, and it seems to be working. So I say it is a good reason to continue on.

Senator D'AMATO. Thank you, Mr. Chairman.

Senator SARBANES. Would you yield for just a point there?

While the banks may have improved their financial position since 1982, haven't American producers suffered and hasn't there been a negative impact on our trade balance because these countries have adopted austerity measures in order to meet their debt obligations, the consequence of which is that they no longer buy American exports? In fact, haven't their own exporters sharpened up their competition against American farmers, for example, and other American producers?

So when you said it is better than in 1982, I take it you mean just the financial side. The banks have their position a little more under control. But one consequence of that is that our producers are in a worse position.

Mr. RAHN. That is absolutely true, and I think you have stated it precisely correct, and that has been an enormous problem.

Mr. CHIMERINE. There is one other aspect to that, too, Mr. Chairman.

A lot of people forget that conditions are very, very bad in Mexico, and other places like that, because of the burden of that debt, and of the austerity measures they have been forced to implement as the condition for more loans, has produced very serious recessions in those countries. And you know, these are not countries that have high living standards to begin with.

And from my perspective, the solution has to be we have to find a way to reduce the burden of that debt not by squeezing down living standards further. Not only is it bad for those people, but it also hurts the United States, as you point out, because it reduces our export markets and it just becomes a vicious cycle. The whole world is close to being mired in this cycle, and this is the risk.

I don't think the risk is really the financial system. It is just a perpetuation of this slow growth on a global basis, and this is one of the reasons why I am concerned that slow growth is likely to continue for many years.

Mr. RAHN. In certain ways you are developing a global welfare state, and we have to be careful of that and make sure that more of these austerity measures we have encouraged or mandated on these countries, that we look at ways to give them incentives for growth, and I think some of the austerity measures that have been proposed and been implemented perhaps have been counterproductive.

The Mexican, typical Mexican, has had a drop of about 45 percent in their real income level since 1982. I don't think Americans would put up with that, and it is dangerous when you have that kind of situation.

Senator SARBANES. Thank you.

Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman and members of the committee and two very distinguished witnesses.

I was interested in some of the comments you made, but before I get into my general questioning I just wanted to ask Mr. Rahn and Mr. Chimerine both very briefly a question with respect to the Canadian timber agreement.

On the whole, would you not give the administration pretty high marks for coming up with a reasonable compromise?

Senator Melcher and I would have liked to have had a 30 percent solution, but if we don't topple the Government in Canada over this, do you think that was a fairly reasonable compromise? [Laughter.]

I can tell you that the timber is available in Idaho, in Oregon, and in Washington that we could take the Canadians head on and out-compete them in the market, but we have a Government monopoly that owns the timber, and they won't sell it to the private enterprise wood processors. We have got the environmentalists to deal with, and this Congress has passed so many laws in the last few years it is impossible for a forest ranger to sell these old dead trees that are going to die and rot anyway, and so it is just a mess.

But you can't change that. So how was the compromise? Do you think it was good or bad?

Mr. CHIMERINE. Yes.

Senator SYMMS. Good?

Mr. CHIMERINE. Good or bad. [Laughter.]

This is going to be a tough——

Senator SYMMS. Just give me a quick answer.

Mr. CHIMERINE. I honestly have not looked at the situation carefully. I think the essential question is whether or not there is a significant subsidy that the Canadian Government is providing to its producers of timber——

Senator SYMMS. Well, they do.

Mr. CHIMERINE. I don't know. I really don't.

Senator SYMMS. Do you think it was a fair compromise?

Mr. RAHN. Senator, you are asking us a political question, and we are economists.

Senator SYMMS. Well, but you talked about political examples in your testimony.

Mr. RAHN. Yes.

Senator SYMMS. Let me give you another one, to get away from timber. A company that is very important to the economy of my State, Helca Mining Co., got involved in a property in Lakeshore, AZ, a few years back. They put $100 million in this thing to mine copper because they knew that the copper producers around the world couldn't produce copper below 90 cents a pound. But they didn't realize how much money the New York banks had lent to all of these countries, so they had to produce copper no matter how cheap it got, and they just had to whip those men in there with guns to break strikes and mine the copper no matter what, to sell it for whatever they could get, so they could make their bank payments.

Hecla finally had to write the whole thing off. It darn near broke the company for a while, and it was a non-Idaho investment. So it concerned a lot of us. It was all political copper.

So you mentioned you taught economic theory? Now, this is getting to my question. I feel like going back and suing the Economics Department at the University of Idaho sometimes because what they taught me is that if you have a bunch of politicians in Washington, DC, who have passed so many laws, they have overregulated, overtaxed, overinterfered with the economy for so long that it is not as competitive as it should be. Then the trade balance gets out of place, so their solution is to debase the currency and we will get the dollar driven down, so then you will end up with high domestic inflation and simply cause chaos.

Well, when you look at the money velocity, how it has dropped off—my question is this—we have depreciated the value of the dollar both psychologically and whatever way that we could. They are printing money like it is going out of style at the Fed, and I keep saying what they taught me in economics in college is that we are going to have massive domestic inflation.

Why don't we have it? What will happen if the velocity of money picks up? Why is the money velocity so slow?

Mr. RAHN. Well, in my opening statement I talked about the huge growth we have had in M_1, which has me worried. I don't know of any economist that can forecast the velocity of money.

And the velocity of money has been low because people now have positive real rates of return of interest, unlike the late 1970's, where they had negative rates of return and they didn't want to hold cash balances.

At some point, though, this could reverse and could cause us a serious inflationary problem, and some of my colleagues have, at times, proposed giving operating rules to the Fed where you would have market basket commodities and looking at those price changes to guide changes in the growth rate of the money supply.

Since this takes discretion away from the Fed, certain folks at the Fed have not looked with great favor upon it.

I think that is a solution. There are a number of other solutions.

Senator SYMMS. Say that again now. You said no great favor at the Fed?

Mr. RAHN. Since this would reduce the discretion of the Fed Governors, there's folks at the Fed who have not looked upon this proposal—and I know some of the proposals you have made—with great favor because it would result in less discretion and more——

Senator SYMMS. Fixed situation?

Mr. RAHN [continuing]. Firm operating rules.

I am very concerned about the direction and the fact that we always fly by the seat of our pants, and Paul Volcker has succeeded during his term if you measure it by bringing down the rate of inflation, but I don't think you ought to build an institution around the basis of assuming that you will have somebody as skillful as Paul Volcker has appeared to be.

Senator SYMMS. Well, he has succeeded in general, except I think the Chairman pointed out the commodity producing sectors of the economy are dying on the vines.

Mr. RAHN. Yes, and it is dying not only because of the monetary policies but the fact that we have State subsidies around the world for basic commodities.

Back when I was teaching I used to assign my students a problem. I would put it in their final exam and tell them beforehand. I wanted them to come up with a solution to what you do with State monopolies that can run with deficits forever, and again the Canadian timber situation fits in there. You are competing with free market economies still if you want to have—if you really believe in free trade and the law of comparative advantage.

Because I couldn't figure out the solution, I kept hoping some smart student would figure it out for me, and I never saw it.

But we take the worldwide sugar situation, which is absolutely ludicrous. We have been producing sugar now, the worldwide price of about 5½ cents. I don't know any country that can produce it for less than 12 cents a pound, and it hasn't been 12 cents a pound, I think, in 5 or 6 years. This shouldn't happen, but it does happen.

Senator SYMMS. Well, most of it, 80 percent of it, though, is under contract by governments. So there's only a little bit that is in the free market part.

Mr. RAHN. Yes. But this is ludicrous for the world, and we shouldn't have to pay 21 cents a pound for sugar nor should sugar producers, like the Dominican Republic—they should be able to sell all their sugar at 12 cents if they are a low-cost producer.

Mr. CHIMERINE. Can I take a crack at that, Senator? I think there are a number of reasons.

No. 1, the money supply measure overstates the amount of money being pumped into the system, but I think we would have to agree nonetheless it has been rising fairly rapidly.

But I think you have to look at the other underlying conditions.

It has been pointed out, first of all, that there is global overcapacity and overproduction of all essential commodities, not only because of increased production but also because demand has been so sluggish. We have had an environment where worldwide economic growth has been very sluggish for many years. There is also overcapacity in most industries, as well as overproduction in commodities.

And that also partly reflects, I think, the sort of debt deflation you pointed out yourself; that is, the impact of a lot of the debt that has been accumulated in recent years is having a negative effect on inflation because it is causing some of the LDC countries to increase production, even if it is not profitable, just to generate some foreign exchange. We are seeing similar effects in certain parts of farmland, and so forth.

So I think when you look at inflation, it is determined by a number of factors. It is not just the money supply—overcapacity, overproduction, high debt, wage cutbacks in order to become more competitive—all of these things are going in the other direction, and for a time, therefore, while they continue, we probably won't have a lot of inflation.

The last part of that, though, is that we have only recently begun to see increases in the price of imports. But the continued downward pressure on the value of our currency will produce even higher import prices and add to inflation. That process is only now starting.

So you will see at least a gradual acceleration in the inflation rate as we move through this year, and probably for the next year or two.

Senator SYMMS. Could I ask one more question on that to both of you?

I have a friend who is in several lines of business, and one of them is oil and gas production. He tells me that right today they can buy leases—lease drilling rigs, drill oil, and put it in production in Texas and Louisiana for $5 a barrel, today's prices, paying the interest, and with the current availability of the drill rigs, and so forth.

So if that is true, how long can OPEC keep this artificial price of $18 a barrel afloat?

Mr. CHIMERINE. I don't think that is true, at least on a widespread basis. The marginal cost of producing oil in the United States is much higher than that.

You know, there might be a specific situation, where you can buy some cheap drilling equipment at distressed prices, where your example might be accurate, but on average, I don't think you can find oil, or produce oil from current wells, at numbers that low.

Senator SYMMS. Well, they do it in Iraq for 32 cents a barrel.

Mr. CHIMERINE. Oh, that is different. You know, you can walk down the street and drill a hole, and you can find oil in Iraq.

Senator SYMMS. I know, I was astounded to hear this marginal cost estimate, too.

Mr. CHIMERINE. All I can tell you is that production from existing wells is now falling very rapidly, and, second, exploration, drilling for new wells, has reached rock bottom in the last year or so. It hasn't been this low in many years.

I think that would suggest that, you know, if you could produce oil at $5 a barrel, I don't think that would be happening.

Mr. RAHN. Can you give us his name? We are looking for investment opportunities.

But seriously with the thing, if you lock at the worldwide supply and demand for oil—and again, as I pointed out earlier, right now we are producing at about 65 percent of capacity—OPEC historically has only been able to maintain control over the price level when we have been up to 80, 85 percent of capacity, and my own judgment is that their present agreement is likely to fall apart because they have enormous incentives to cheat. All of the major producers do with expanding production.

Given this, I would expect a drop in the price, and I would guess it may happen this spring. But it is clear that over the long run, given the very sizable declines that Mr. Chimerine referred to in the United States in our production and the fact that a lot of the old fields, the North Sea fields, will start to decline, that in the next 3 to 5 years that supply-demand ratio will tighten up and that we can expect then big and sustained increases in price levels for a while.

Senator SYMMS. Well, my time was expired, and I thank you both very much.

I might just make a comment to the two economists here in closing, Mr. Chairman, that I had lunch last week with the Economic Minister from France. He made a comment to me in the conversation that is amusing. He said one thing that he always thought as a young man when he was at the university, that one thing the Western Alliance could finally agree upon would be to do away with farm subsidies, so we could all have a more market-oriented agriculture in the United States and Western Europe. But he said it certainly hasn't worked out that way in his practicing years as part of the French Government, that they have never been able to do it politically in France nor have we been able to do it here in the United States, and so we can't get the equilibrium back in line.

What I am concerned with in Argentina and Brazil is they won't stop production, even though if Senator Melcher and I get our way and cover the world with the American grain that is now being stored, they will still produce it.

I hope that that is not true, but——

Mr. CHIMERINE. Well, if I can comment very quickly on that, Senator, I think the environment is not favorable for that because the weaker demand is on a worldwide basis, and the more sluggish conditions are, the more likely everybody is going to try to protect their own market and try to get a sizable share of somebody else's.

In a more vibrant world economy you can perhaps do that. Conditions would be better, prices would be higher, and perhaps you can move more toward a free market approach.

But we are moving increasingly in the opposite direction because of weak conditions, and this is one of the reasons I think the current situation may feed on itself, and it just gets worse and worse.

Senator SYMMS. And if the Soviets ever let the farmers run the land instead of the bureaucrats, well, there won't be any market for the Westerners.

Mr. CHIMERINE. You are probably right.

Senator SYMMS. No, but I mean it is a fact. I mean they have twice as much ground as we have and better—I mean, they could bury the world in wheat if they would just get rid of the bureaucrats and just let the farmers own it and farm it. I mean, they would just cover us up with it.

Mr. RAHN. But it is a frightening thought. You are right, though.

Senator SYMMS. Since I am a farmer, I worry about it every night.

Senator **Sarbanes**. Let me just ask a couple of questions on the second round. Then I will turn to Senator Melcher.

First of all, Mr. Rahn, I think your point on the state-run economies is a good one. We are working in this international environment, and my perception is that countries that are "free market" are doing a great deal of the same thing and that is a source of our problem. Japan, for example, the French obviously, and others as well.

And in that sense I am not sure that the classic free trade approach is necessarily going to work for us. I don't see how we get enough leverage taking that approach to pressure these countries to alter some of those policies.

That is not to argue for protectionism. I think we need to break out of that framework of thinking, very frankly. I think there are problems and we need to address them in a very pragmatic way and that immediately pigeonholing something as protectionist or, the alternative, as free trade doesn't help us very much.

I think we have a real problem in terms of our competitive situation because I see our producers as coming up against not simply foreign producers but foreign producers aligned with foreign governments and with foreign labor, for that matter. They have all joined in a partnership to deal with us, and we are in a fragmented position.

I don't have an answer to that, but simply maintaining this kind of adherence to traditional doctrines is not working because they are using it to come in and establish their beachheads in our markets.

Mr. **Rahn**. As I said earlier, I think that is the great trick is finding ways to open up foreign markets and get them to respond in an economically rational way. For instance, in the case of Canadian timber, their idea that the timber has no cost to them is economically ludicrous. But we have to find ways of getting them to be responsible without penalizing ourselves.

At the Chamber we have struggled trying to develop a series of specific policy recommendations for you to deal with this problem. Sometimes I have thought that the best thing we could do is advertise to the Japanese consumer and ask the Japanese housewife why she is paying a dollar an orange and $12 a pound for beef when, if Japan was a true free trade country, she could have the same prices that we do.

My fear, and our fear down at the Chamber, is that some of these proposals that are coming out of the Congress are old-fashioned protectionism; these are likely to result in retaliation and no improvement in trade at all. They won't result in an opening up of markets but in driving up the cost to the U.S. consumer. We will be working with you, and pass along our suggestions on how to deal with this problem. I hope that Congress will be very cautious and look at the possible consequences of any particular action.

To the extent that an action is likely to open up a foreign market or get foreign firms to respond in a more responsible manner, we are all in favor. To the extent that it would greatly increase the prices for the U.S. producer and consumer, we would be strongly opposed.

Senator **Sarbanes**. Let me touch on one other thing. I want to come back, in a sense, in defense of forecasters. Let me ask each of you what you predicted for GNP growth for the year that has just finished, 1986. Do you recall what you predicted a year ago?

Mr. **Chimerine**. Yes. I think at this—I don't know if it was in this same room, but at a hearing held by this committee a year ago, I predicted 2 to 2.5 percent on a fourth quarter to fourth quarter basis.

Senator **Sarbanes**. And what did you predict, Mr. Rahn?

Mr. **Rahn**. I predicted 3.6 percent. I have been overly optimistic the last 2 years. In 1983 and 1984 we were very close to target. A year ago we had a very good CPI number, but I will confess to being too optimistic for the last 2 years.

Senator **Sarbanes**. OK. So the Commerce Department has told us now it was preliminarily around 2.5 percent.

Mr. **Chimerine**. Well, I think that is year over year, Mr. Chairman. On a fourth quarter to fourth quarter basis, it was probably around 2.2, wasn't it?

But that is close enough. I will accept your statement.

Senator **Sarbanes**. Well, the reason I come back to this is because it seems to me we have to have these forecasts because a lot of things are premised on them. The President's whole budget is premised on forecasts. They make numerous assumptions and then on the basis of those assumptions they make a lot of predictions.

So the reasonableness of the assumptions they make and the reasonableness of the resulting predictions is pretty important.

Now, forecasters range over the lot. But it is a matter of some concern if the executive branch of the Government, or the Congress for that matter, is using assumptions and making predictions that are outside of the scale or, secondarily, very much at the upper end or the lower end of the scale, which ought to cause one at least to wonder about the accuracy of those predictions.

Let me ask you, Mr. Chimerine, when you look back over the prediction you made in which your overall figure came out pretty well, did your component figures come out pretty well also, or did you have two major errors underneath that canceled one another out?

Mr. **Chimerine**. I would have to look back, but I would guess, Mr. Chairman, that consumer spending was somewhat stronger than I thought a year ago, and while I wasn't really optimistic about the trade deficit, it probably turned out even worse than I thought. So there was probably an offset among those two components.

The rest of it, as far as my memory goes back, was probably reasonably close. But if there were significant errors, offsetting errors, it was in those two categories.

Senator **Sarbanes**. Mr. Rahn, where did you go wrong in those 2 years in terms of——

Mr. **Rahn**. Oh, on export growth we were clearly off on that. I have to go back and look at all the various components. I know we did very well in terms of the CPI level. We underestimated consumption spending slightly. We were too optimistic on business investment.

And along with that, I was just looking—I just pulled out the new Blue Chip forecast and I was looking for 1987, where the range goes from a high of 4.1 to a low of minus 1, and I realized that you are absolutely right, we have to come up with forecasts in order to make certain judgments about policy options, but my recommendation is that you take a moving average of the best of the private forecasters and use their consensus as a starting point. That would probably be the one that would give you the least amount of political bias, and we would probably be best off if you took a 5 year moving average of the top 20 forecasters, you would have a reasonably reliable guide for policy purposes.

Mr. CHIMERINE. If I could make one quick comment, Mr. Chairman, I think when you decide what kind of forecast to use you have to take into account the fact that they are all going to be wrong to some degree—I mean, if you go out to enough digits, every forecast is wrong, and in recent years you haven't had to go out to too many digits after the decimal point. The key, I think, is what the risks are and——

Senator SARBANES. What the risks are?

Mr. CHIMERINE [continuing]. What the risks are, and what the costs are.

In my view, in recent years, it has been a terrible mistake to base budget policy on these relatively optimistic forecasts because that delayed taking real action on reducing deficits. It made it look as if we had a potentially free, easy solution, and as a result we didn't bite the bullet earlier when we should have. We just perpetuated these high deficits much longer, and I think the risk inherent in that was so enormous that it was unwise to develop our budget projections on that basis.

That has been my argument all along, and it has turned out that way. But the point is, we didn't know that earlier. But we did know that the forecasts that were used by the administration were on the optimistic side and, second, if they were wrong it meant we would just go deeper and deeper and deeper into debt. I felt that was to risky at the time and I still do. And that is the main reason why I think we shouldn't be using optimistic forecasts because we are just delaying taking the real action on what is a serious problem that is undermining, in my judgment, the long-term outlook for the economy.

So I think you have to take the risks of that, and the costs associated with it, into account.

Senator SARBANES. Senator Melcher.

Senator MELCHER. Senator Symms was alarmed if the Soviet bloc would become more proficient in farming that they would take over all the world markets.

But I think what we have been seeing in Soviet Russia is the normal course of events. If you are going to improve your well-being, you want a better diet, and it comes pretty natural to all of us, and rather than just eating a pound of corn as a meal for the family they have determined they are going to put some corn or wheat into livestock or poultry. And it takes serveral pounds of the corn, about 8 if they are proficient, to get 1 pound of beef or 6 to get 1 pound of pork or 4 to get 1 pound of chicken. If the family eats that 1 pound of chicken or beef or pork, they are eating the equivalent of a large amount of grain. The same with dairy, of course.

What we are seeing also in China is turning to a better diet that is more appetizing, more satisfying.

But, Mr. Rahn, I think you answered my question about the inflation factor by saying that is it impossible, that agricultural commodity prices are not going to improve because it isn't going to happen. But I have to go back to what I earlier said.

There's about 20 of us here in the Senate, perhaps more, that are very much concerned and very much determined that the agricultural exports from the United States will increase and will increase this year, and sizable increases. And the reason we are very likely to be successful is that I believe the administration is going to agree that we should do this for a number of reasons, but also because if the commodity prices—for wheat, corn, and soybeans—do level off, start upward again, that the drain on the Treasury for deficiency payments to farmers will be reduced. That is the way it works.

Now, because I think it is going to happen this year I just want you to view it in that way, if you will, for a moment or two, and it is very possible—we know it is possible. I will give you three examples.

In the Philippines, the farmers were demonstrating yesterday, 12 hours ago or 14 hours ago, because they want land reform, and the Aquino government assuredly would like to have land reform, but under law, under their law, it means compensating whoever owns the land and that takes some money.

Let me point out that under a variety of programs that we have—take the food that is donated or sold very cheaply, either way, and can be converted to cash on the local market. Does that satisfy needs? Of course it does.

There is a vast number of poor in the Philippines. Wheat and milk are not produced there and never will be produced there. So there's markets for those products. They can use that—under our law they can use—we can either sell it to them very cheaply or make outright donations and they can convert that into capital.

That is one of the possibilities that has not been used. We think it ought to be. We don't think every country is alike, but we think it ought to be used that way in the Philippines, our donations or our very cheap sales.

Senator SARBANES. John, let me interject——

Mr. MELCHER. Yes, please.

Senator SARBANES [continuing]. Before Mr. Rahn responds. Mr. Chimerine has a plane to catch, as I understand it, and I would like to excuse him if——

Mr. MELCHER. Certainly. He has already given me his reaction to this.

Senator SARBANES. We thank you very much. You have been a very helpful witness.

Mr. MELCHER. Thank you.

Senator SARBANES. We appreciate it.

Mr. MELCHER. The second example, Mr. Rahn, would be Mexico. We are in the position to—and should by all means pursue it immediately—to give extremely favorable terms on wheat sales. To the extent that they get the wheat from us on that basis, or whatever other commodity, whether it is soybeans or any other commodity, on that basis they save themselves some cash and pay for it down the road a piece, wherever we want to set it.

And last, the third example I will give you is India. I am told that India exports wheat. India exports some wheat for hard money. Their overall nutrition is very low, poverty is very high. So it is another example where the market is there depending on whether we want to use the opportunities we have, and since we set the policy here in Congress, with a willing administration, which I think will be willing this year on this—given that set of circumstances, it will have some inflationary effect, would it not?

Mr. **Rahn**. The fact that we give this?

Mr. **Melcher**. Or sell it very cheaply or sell it for very long term.

Mr. **Rahn**. Have an inflationary effect on the United States? I think that effect would be minuscule.

Mr. **Melcher**. I agree. I agree because we have got several steps before we reach the consumer here.

Mr. **Rahn**. It is clear that the United States ought to be the world's lowest priced producer of many basic feed grains due to our technology and endowment of resources.

If we could find a way to have a free market we ought to strive for it. I am somewhat baffled as to how we get there and I don't really have any great advice for you on that.

My further point is that if we are now producing, worldwide, far more food than the world is consuming, you really limit markets for export unless we engage in massive export subsidies in the way that the Europeans are doing. Ultimately, all this becomes self-destructive.

So I guess that my recommendations would be that we work hard to try to get other countries to reduce the size of their export subsidies and get the world on a more rational basis when it comes to agriculture. Domestically, that we work toward finding humane, compassionate ways of getting the excess number of farmers off the land and reduce our output over time, instead of subsidizing output the way we have, which adds ultimately to our problems rather than reduces them.

Senator **Melcher**. Well, I think we are a long way from either getting away from subsidizing farmers that are producing vast amounts of agricultural commodities here in the United States, but we are also a long way away from satisfying adequate nutritional levels in the world.

But I think you have answered my question on the oil side of it. I suppose at the same time I read today Mexico increased both their heavy oil and their light oil by, I believe, 40 cents a barrel. They must feel that that won't disturb their market.

But nevertheless, as I interpret your responses earlier dealing with world oil prices, you don't feel that OPEC can hold together to establish an $18 a barrel world price?

Mr. **Rahn**. Given the present supply and demand conditions, no. The only way I think that is sustained over time is either a big surge in worldwide demand or a big decline in supply.

For instance, if we say the Iraqi-Iranian war even heated up more than it is now and they destroy more of each other's capability to export oil, that could keep the price up there for a while. But my own feeling—and again it is just looking at the evidence and looking at history a little bit—is that oil prices are likely to fall somewhat again in the spring.

Senator **Melcher**. All right, thank you very much.

Senator **Sarbanes**. Thank you very much, sir. We appreciate your coming. We appreciate your testimony. It has been very helpful to the committee.

Mr. **Rahn**. Thank you very much for inviting me. I enjoyed being here.

Senator **Sarbanes**. Thank you.

The committee will recess until 10 o'clock in the morning.

[Whereupon, at 12:15 p.m., the committee recessed, to reconvene at 10 a.m., Friday, January 23, 1987.]

[The following information was subsequently supplied for the record:]

TESTIMONY ON THE ECONOMIC OUTLOOK
BEFORE THE JOINT ECONOMIC COMMITTEE

January 22, 1987
by Dr. Donald Ratajczak
Director
Economic Forecasting Center
Georgia State University

I greatly appreciate being invited to offer testimony on the economic conditions of this country before this important congressional committee. Although my outlook for economic growth in 1987 is not substantially different from the 2.5% growth channel that began emerging in the second half of 1984, substantial changes in the relative performance of economic sectors will significantly alter economic prospects by region and by industry.

Effects of Tax-Shifting on 1986 and 1987

Radical income tax changes will generate several negative influences upon economic events in 1987. Evidence of shifting economic activity into 1986 at the expense of 1987 can be identified in the automobile, capital goods, and construction industries. Nearly 250,000 additional automobiles apparently were sold in December because of that last opportunity to acquire a sales tax deduction for such purchases. This pushed automobile sales to more than 11.4 million, but almost certainly will reduce sales early in 1987. Excluding the effects of tax-shifting automobile sales were projected to decline by 0.6 million in 1987. Tax shifting sales add a further decline of 0.5 million from 1986 totals, leading to automobile sales of only 10.3 million. Most of this weakness will occur early in 1987.

Because of a perception of more favorable depreciation schedules under the old tax codes than in 1987, capital goods orders and shipments were especially robust toward the end of the year. Nearly $4 billion of capital spending may have been diverted to the fourth quarter at the expense of the first quarter of 1987. As a result, economic activity was more robust at the end of 1986, but will slow significantly early in 1987.

Construction shifting is more difficult to determine. Because tax law changes dramatically increased the costs of maintaining unutilized construction inventory, a substantial decline in acceptable vacancy rates for rental properties and commercial property will be the ultimate outcome of the tax changes upon the construction industry. However, some developers may have accelerated construction during the latter half of 1986 in order to insure that projects could receive the nineteen-year accelerated cost recovery treatment.

Under new tax considerations and prevailing rental rates, desired inventories of rental property are projected to be only marginally higher than 4%. This compares with actual vacancy rates of 7.5% during the third quarter and vacancy rates in excess of 10% in the southern region at that time. Again utilizing prevailing rental rates and new tax codes, acceptable inventories of commercial space probably will fall until vacancy rates again decline below 10%. Current vacancy rates exceed 21%. As a result, construction activity will be deeply depressed in 1987 and continue to remain lackluster for the remainder of the decade. According to my estimates, commercial space completed in 1985 totaled 345 million-square-feet. Such completed space in 1986 probably will total 280 million-square-feet. Completions in 1987 are projected to fall to only 220-million-square-feet with a further decline to a recessionary 180 million-square-feet in 1988.

Multi-family housing units, which were completed in excess of 650,000 units in 1986, should experience a completion rate of only 520,000 units in 1987 and 480,000 in 1988. Activity then can begin recovering.

The effects of resource-shifting because of tax changes appears to have bolstered economic activity after inflation by more than $12 billion at annual rates in the fourth quarter. Nearly that amount of activity should be subtracted from the first half of 1987.

Other Effects of Tax Changes

As mentioned above, the new tax laws will sharply reduce the value of holding unoccupied construction product. As a result, a significant inventory adjustment, will be accelerated because of the tax law changes. Although considerable uncertainty surrounding the speed of this inventory adjustment remains, construction, which added 0.6 percentage points to economic activity in 1986, will remove 0.6 percentage points from growth in 1987. This outlook is somewhat at odds with the administration's projections that construction will continue to be a modest contributor to economic growth in 1987.

Although corporate taxes increase substantially in 1987, largely as a result of the alternate minimum tax and the repeal of the investment tax credit, taxes for households are generally reduced, largely because of significant increases in the exemptions and deductions allowed on 1987 income. In general, tax revenues are scheduled to increase by $11 billion in 1987 as a result of the tax reform package. Many economists have argued that benefits to the household sector will stimulate consumption, even as reduced cash flow in the corporate sector may restrain investment activity. While consumption probably will rise for lower income households, the magnitude of this tax benefit has been substantially overstate. In fact, corporations will attempt to maintain appropriate returns on equity in order to encourage continued stockholder acceptance. In some instances, higher tax costs associated with the changed corporate tax environment will be reflected in higher prices. This is expected to be most substantial in some of the service and fast food areas. (Although tax increases are not dramatic for those enterprises.) For industries currently facing foreign competition, price increases are not a viable option. Those enterprises probably will attempt to increase efficiencies thereby slowing employment gains, and also restrain wage increases. Most wage surveys for 1987 suggest that wage gains will be half a percentage point less than in 1986.

If corporations respond as outlined above, those households with increasing purchasing power from each dollar earned may discover that fewer household members are working or that anticipated wage gains are reduced. In any case, the effects of tax reform upon consumer spending aside from the aforementioned shifting of purchases is not expected to be significant in 1987. More substantial increases in consumer spending may surface in 1988 when reduced marginal tax rates lead to an effective tax cut in that year.

On the other hand, reduced investment activity resulting from reduced corporate cash flow and the direct adverse effects from loss of the investment tax credit probably also have been overstated. If corporations try to maintain their cash flow by either raising prices or restraining labor costs, the magnitude of the cash flow problem will be far smaller than initial conditions would suggest. Some capital spending probably will be reduced in 1987 because of the tax changes, but the magnitude is not expected to be substantial.

Although the near-term impact from tax law changes will be adverse to economic activity, our own analysis strongly suggests that the tax changes will have beneficial effects over the long-term. One of the largest restraints upon capital accumulation will be in the inventory holdings of construction product. There is strong reason to believe that these heavy inventory holdings, which were induced by previous tax laws, led to inefficient capital accumulation. Of course, the previous tax laws also led to rental rate subsidies. Therefore, inflation rates for rental services will probably be higher over the next five years than in the absence of the tax changes. These rental increases, however, should not occur until after the inventory of rental property approaches desired levels.

With reduced construction inventory, but little change in actual usage of construction product, interest rate pressures should be lower than otherwise would prevail. Reduced interest rates can lead to more accumulation of other forms of capital than otherwise would occur. Thus, although total capital accumulation will slow under the new tax codes, capital utilization will increase significantly. Indeed, economic growth should be enhanced by the tax law changes over the next ten years.

Other Influences Upon the Outlook

Although the shifting of automobile spending into the fourth quarter of 1986 undoubtedly will slow consumer spending growth in 1987, growth of consumer spending probably would have slowed anyway. Savings rates are unusually low, less than 2% in December. The ratio of installment debt to disposable income is unusually high. During the past three years, consumer spending has grown more than a percentage point a year faster than economic activity. This more rapid growth has been achieved by three factors.

First, purchasing power has been transferred from agricultural and energy producers to the household sector. To the extent that some energy producers were from abroad, this was a net benefit to the household sector. In 1986, such transfers enhanced household purchasing power by $25 billion. No such transfer of purchasing power is on the horizon for 1987.

Second, consumers have been more able to service their debt as a result of falling financial charges. The use of financial subsidies to sell automobiles and the surge in home mortgage refinancing early in 1986 reduced monthly payments for debt servicing by more than $200 for the average household. Automobile producers may continue to use financial subsidies to sell their cars. In addition, declining interest rates probably will permit some further opportunities for mortgage refinancing during the spring of 1987, when conventional mortgages are expected to be 8.5%. However, the ability to reduce financial costs to service debt balances will be much smaller than in 1986. As a consequence, consumer debt burdens will begin to restrain consumer spending this year.

Third, a significant number of households, hold significant stock and bond assets. Their asset holdings have appreciated in market value much more dramatically than their debts have increased. Household assets in 1986 expanded more than 1.5 times more rapidly than household debt. The latest stock market surge strongly suggests that these consumers can continue to increase spending more rapidly than incomes in 1987.

When all of the forces for restraining consumer spending are compared to the continued benefits of swelling asset values held by some households, consumer savings probably will remain low, but will not fall from their 1986 averages. A reduced savings rate in 1986 contributed nearly a percentage point to economic growth. Indeed, if the appreciation of household assets begins to diminish, debt burdens and associated bankruptcies could rise dramatically in 1987, leading to less consumer support for the overall economy. Such an outcome is not expected, but cannot be dismissed either.

Trade

Thus far, my analysis indicates that tax shifting, reduced capacity to support consumer growth, and a construction slump all will lead to significantly lower economic growth in 1987 than in the past four years. However, much of this weakness will be offset by improvement in real net exports.

Though the dollar has been falling in value for almost two years, there has been little noticeable effect upon increased export opportunities, and virtually no effect upon restraining import flows into the United States. Part of this poor response to the weakening dollar has been caused by failure of the dollar's weakness to significantly increase import prices. For example, prices of imported industrial materials other than petroleum showed their first increase only in the third quarter of 1986.

Poor transmission from the dollar's falling value to changing price signals appears to be the result of several factors. First, the dollar has not fallen significantly in value against the currencies of countries that are significant suppliers of industrial materials to the United States. While American producers have increased their competitiveness against Europe and Japan, competitive positions have either remained unaltered or deteriorated until early 1986 against such important importers as Canada, Brazil, Taiwan, and South Korea. Thus, the origin of some imports has changed, but the volume of imports has not been significantly altered.

Second, the industrialized nations that previously had captured significant markets in the United States were reluctant to lose market share. They, therefore, absorbed exchange rate changes in the profit margins for their products. In some cases, these profit margins were substantial prior to the dollar's weakening. Therefore, only limited price changes have resulted from the dollar's decrease in value, against major currencies.

At the same time, attempts to wrestle our markets back from the industrialized countries began to slow economic growth in those countries. Both Germany and Japan currently are growing at 2.5% real rates of expansion. Although currency values have increased the competitiveness of American producers in those countries, slow growth has diminished opportunities for American exports. Also, American exporters traditionally held more than normal shares of foreign goods flowing into petroleum producing countries. When their incomes declined, American sales fell.

In 1987, further weakening of the dollar appears likely. Even the unusually low exchange rate levels recently established between the American currency and the Japanese yen and the German mark do not appear to be sufficient to substantially reduce the trade deficit.

Because of increased oil consumption and reduced oil production in the United States, imports may actually rise. As a result, only a significant expansion in exports, or a sharp curtailment of non-oil imports will lead to any substantial reduction in the trade deficit. At the present time, I am currently projecting slightly less than a $20 billion improvement in the trade account. My feeling is that this will not be a sufficient reduction in the additional dollar assets that foreign investors must hold to prevent further weakening in the dollar's value. Indeed, a decline in the dollar to 1.6 German marks and 135 yen may be required before significant and persistent improvements in our trade accounts is assured.

We feel the Administration's suggestions that trade balances could improve by $40 billion in 1987 are excessive. Even with improved competitiveness as a result of a falling dollar, exporters are more capable of garnering the lion's share of growth in foreign economies rather than displacing domestic suppliers from their traditional markets. With growth in the industrial economies sagging to only 2.5% - 3.0% in 1987, export growth from the United States in excess of 6% - 7% probably is unattainable.

Of course, domestic substitution for imports could intensify, especially as prices of imported materials are now beginning to rise. For some industries, such as textiles, some import substitution is possible. In the automobile industry, however, steep perceived quality differences between domestic and imported cars may preclude any substantial decrease in import penetration. Nevertheless, some import displacement could gradually materialize as import prices continue to rise. Unfortunately, most of this benefit will be offset by the need to increase imports of oil product.

When the improvement from rising trade deficits to slightly narrowing trade deficits is added to the analysis, industrial activity will expand more substantially in 1987 than in 1986 while economic activity will grow nearly similar rates in both years.

Inflation

Because of the surprisingly good price performance in 1986, many analysts are failing to emphasize the reappearance of inflationary problems in the next two years. However, the dollar's weakness will generate increasing inflationary pressures, especially now that importers no longer have profits with which to absorb exchange rate changes. Further dollar weakness will more rapidly and more substantially be translated into price inflation during 1987 than in 1986. Also, energy prices are not expected to decline in 1987. The significant slowing in inflation during 1986 is totally attributed to price weakness in the energy sector.

Fortunately, when energy prices were falling, wage pressures began to abate. More modest wage gains should persist in 1987. This will restrain inflation in the service economy for much of this year. Thus, even as commodity prices begin to increase following a rare year of decline, consumer prices will grow by less than 3.5%.

However, intensifying inflationary pressures will be apparent during the latter part of 1987. By that time, firming oil prices will begin to lead to higher inflation than in 1986. Wage pressures should intensify while further dollar weakness will begin to create significant price pressures for imported goods. Moreover, a significant increase in social security taxes in 1988 will add a modest cost push factor to inflationary pressures in that year. Thus, signs that inflation may boil over 5% could appear as early as 1988.

Policy Alternatives

When energy prices were falling substantially in 1986, it was appropriate to rely heavily upon the Federal Reserve to maintain a reasonable level of economic expansion. At that time, vigilance over inflation was not compelling.

As inflationary pressures begin intensifying with the falling dollar and the reversal of declining wage pressures, neglecting vigilance over inflation will become increasingly dangerous. Therefore, the Federal Reserve should return to its more traditional concern of the inflationary environment and begin to restrain growth of Federal Reserve credit if significant inflation reappears. Of course, I would hope that the Federal Reserve would overlook the moderate inflationary resurgence that higher oil prices will be generating in the CPI during January and February. This inflationary surge may prove to be temporary and should not be a cause for policy change unless intensifying commodity inflation persists into the spring.

If the Federal Reserve will begin shifting more toward restraining inflation and diminish its concern for re-accelerating a sluggish economy, as I believe it should, then budgetary and tax policy would need to more significantly address problems of sluggish economic growth. Unfortunately, high deficits preclude any budgetary stimulus unless dramatic economic slowing resurfaces. As long as government deficits are sufficient to create more rapid growth of government debt than of economic activity, budgetary policy should be addressed toward reducing that debt burden. However, when deficits fall below $100 billion, government debt no longer will be growing more rapidly than economic activity. At that point, further restraint of deficit financing even in an economically weak environment becomes much less compelling. Indeed, unless a recession can be avoided through 1991, an historically unlikely possibility, current Gramm-Rudman legislation leading toward a balanced budget at that time eventually will prove to be economically counter-productive.

In the longer run, the U.S. economy needs to be restructured away from stimulating consumer activity and toward developing industrial capability. When foreign investors decide that they no longer wish to accumulate American assets, we must have the capacity to earn sufficient surplus abroad to repay foreign debt. In other words, U.S. economic structure needs to be redeployed more toward consumption restraints and industrial expansion that is required of a developing economy than the broad consumer activity that can be justified in a mature economy with significant foreign credits.

The latest tax revision significantly reduces marginal tax rates, but does very little to alter the investment, savings imbalance that continues to preserve high interest rates relative to underlying inflationary pressures. It also does little to diminish consumer spending and increase industrial development. Therefore, any revenue raising programs probably should concentrate upon restraining consumer spending rather than again adjusting income taxation. Concerns that consumer-oriented taxation will more heavily harm those who are least able to bear higher taxation can be addressed by providing an income tax credit to offset any excise or sales tax burdens that low-income households might experience.

Once again, I appreciate being invited to address this congressional body and I hope that my comments aid in your deliberations.

THE 1987 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, JANUARY 23, 1987

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to recess, at 10:10 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes, Melcher, and Bingaman; and Representative Wylie.

Also present: William R. Buechner, professional staff member.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The Economic Report of the President for 1987 will be presented to the committee on Thursday, the 29th of January by Beryl Sprinkel, the Chairman of the President's Council of Economic Advisers. Joining him will be the other two members of the Council, Mr. Moore and Mr. Mussa.

Today's hearing, like yesterday's, is designed to help set the context for the committee's review of the President's Economic Report. Yesterday's hearing was devoted to the economic outlook for 1987 and this morning we will focus on international trade and international economic policy.

Perhaps nothing indicates more dramatically the importance of the problem facing our country with respect to international trade and economic policy than the meeting earlier this week between Secretary Baker and Japanese Finance Minister Miyazawa. Minister Miyazawa came to this country on very shot notice for a lengthy meeting to discuss the recent rapid decline in the value of the dollar. The results of the meeting were carefully limited to a formal acknowledgment by both parties of temporary instability in exchange markets, a reaffirmation of both parties' willingness to cooperate on exchange market issues, and a reminder that to promote global growth, reduce imbalances, and promote open markets, closer cooperation of economic policies among all industrial nations is critical.

Now this hastily arranged meeting serves to bring into sharp relief the challenges arising from the fundamental change in the international economic environment, which the Nation must now confront, an environment in which for the first time the U.S. economy must perform effectively if it is also to be successful at home. The transformation has been not only profound, but swift. For most of our history, our economy has been remarkably self-sufficient. The period of reliance on foreign capital to finance industrial expansion lies beyond the reach of modern American memory. Since World War I, the United States has been a creditor nation, in fact, the world's preeminent creditor nation.

In the period following World War II, the United States was in a position to oversee the creation of an orderly international monetary system and to underwrite the reconstruction of the European and Japanese economies that were ravaged by war. It did so under the well-founded assumption that not only Western Europe but the United States would benefit from a vigorous international economy.

Perhaps what was not foreseen at the time was that our major trading partners would also become major trading competitors, or that other nations, whose economies were inconsequential 40 years ago, would emerge and participate vigorously in all aspects of international economic activity.

The change in the U.S. position over time has been reflected in the figures that show imports as a percentage of GNP in the postwar period. Until 1955, that was below 5 percent. For the next 20 years, through 1975, it remained below 10 percent. From 1975 through 1982, it fluctuated between 10 and 11 percent, and since 1982, it has risen steadily. It was 14.2 percent in the year just ended.

Now the situation confronting us today reflects the failure of our exports to keep pace with the rapid acceleration in our imports. Over the past 6 years, we have imported $629 billion more in goods than we have exported, accumulating 70 percent of this deficit in just the last 3 years. Our merchandise deficits have overwhelmed the small surpluses traditionally earned on U.S. foreign investments. United States borrowing abroad has, therefore, been necessary to finance these deficits.

As a consequence, we moved from being a creditor to a debtor nation for the first time since World War I. This shift has caused immense problems for the American economy, including significant job losses, farm failures, depressed profits. In addition, the huge U.S. trade deficit has also created problems for the world economy. Much of the world has become dependent on exports to sustain the standard of living. In a sense, the German and Japanese surpluses are the mirror image of the U.S. trade deficit. No major power in history has run trade deficits of the magnitude which the United States has experienced over the past 3 years, just as no such power has run trade surpluses of the magnitude which Japan has accumulated.

The U.S. trade deficits built up over the past 6 years are the result of a more rapid growth in consumption than in production. Imports have filled the gap. Reducing the trade deficit will require a prolonged period in which the pattern is reversed, and in which consumption grows at a slower rate than production.

The purpose of today's hearing is to define the problems and examine the policy options available to us as we confront the huge, and ultimately unsustainable U.S. trade deficits. We are fortunate to have as our witnesses two distinguished experts. We were to have three, but Fred Bergsten, the director of the Institute for

International Economics is snowed in. We are very grateful to our other two panelists that they have made it here, with some difficulty, as I understand it.

So our two panelists will be Lionel Olmer, partner in the firm of Paul, Weiss, Rifkind, Wharton & Garrison, former Under Secretary of Commerce for International Trade in the U.S. Department of Commerce, and Gerald Holtham, visting fellow at the Brookings Institution and former head of the General Economics Division of the OECD in Paris.

Gentlemen, we very much appreciate you being with us today. We look forward to hearing from you.

Before you start, I turn to my colleagues, if they should have any opening statements they want to make.

OPENING STATEMENT OF SENATOR BINGAMAN

Senator **Bingaman**. Mr. Chairman, this is the first meeting I have had the pleasure to attend here on this committee since being appointed, and I commend you for the importance of these hearings that you are holding. I think it is a bit ironic that so much attention is being payed to the hearing down the hall on a foreign policy issue, which, of course, is of interest. I do think that this is another foreign policy issue or a complex of issues that perhaps in the long run will have a greater impact upon us, and I commend you for focusing our attention on it.

Senator **Melcher**. I have no comment, Mr. Chairman, except to welcome the witnesses this morning.

Senator **Sarbanes**. Well, thank you, Senator Melcher. I would just want to welcome Senator Bingaman to the committee. We know of his keen interest in a number of economic issues, and we know he is going to be a very valuable member of the committee, and we are pleased to have him with us.

Mr. Olmer, I think we will start with you, and we will hear from both of you and then turn to questions.

If you could take that microphone in the middle and use that one as well, it would be helpful. The court reporter is not yet here, so we are recording the hearing through that microphone.

Please go ahead.

STATEMENT OF LIONEL H. OLMER, PARTNER, PAUL, WEISS, RIFKIND, WHARTON & GARRISON, AND FORMER UNDER SECRETARY OF COMMERCE FOR INTERNATIONAL TRADE

Mr. **Olmer**. Thank you, Mr. Chairman, members. It is a privilege for me to be here again, and I will try and limit my comments to a few brief highlights of the prepared statement which I have prepared and you have before you.

In the course of thinking about coming before the committee and what I might say to help direct your efforts in the coming weeks, it was immediately obvious to me that I could only hope to highlight a few of the issues that confront the country, the Congress, and the administration, and so I selected only those that I know a little bit about and wrote somewhat in Olympian fashion regarding the macroeconomic problems of enormous magnitude which are not my field.

I guess I would like to start by saying that in my judgment our international trade problems have not yet turned around, not by a long shot. The depth of the difficulties that the trade deficit has caused have not been plumbed yet. But it is encouraging in one sense to realize that the Government, as a whole, finally agrees that there is a problem.

I might point out that this common understanding was a matter of years in coming, however. Until fairly recently there were those that did not believe trade deficits made any difference. They referred to the current account as more important, and when we began posting a current account deficit, the emphasis shifted to the importance of our international debt payment position which, as the chairman pointed out, has also shifted into deficit.

Finally, it would seem, folks are backed into a corner and acknowledge that we have very severe problems confronting us. In my opinion, the issue that remains unresolved, in terms of achieving a consensus in government, is whether or not this country requires a strong industrial base as the driving element in the economy. Do we need a manufacturing sector, or can we rely on services and high technology as the key to the future?

It is my opinion, and I try to back up my opinion with some observations in the prepared statement, that we absolutely, without qualification, must have a strong manufacturing base which is internationally competitive.

I further try to make the point that the question of competitiveness, which is now absorbing almost everyone in Washington, should not be left only to large multinational corporations to define. Even during this difficult economic period that we have been transiting in the last few years, many American companies have been quite profitable in their balance sheet. The question is, How have they been making money? Many of them have been shifting their activities overseas. They have given up exporting. They are relying on foreign sources for component parts and merely assembling in the United States, or they have entirely relocated manufacturing abroad. Obviously, there are job loss consequences to that kind of a tactic, a survival tactic, as I put it. It is not bad, but it is not necessarily consonant with the larger U.S. national interest, and that, I submit, is a policy question of first-order magnitude for the committee's attention.

Second, I believe that there has been an impact on the national security interests of the United States because of the trade deficit and the erosion of our manufacturing competence. But the national security impact has not been adequately measured, and I would urge the committee's attention to that as an issue for 1987.

You will find people in the administration, both present and past, who will argue that there has been no harmful impact, that industrial restructuring is inevitable, as a law of nature, that nothing is so certain as change, and that what we are witnessing is the mere alteration of the nature of the U.S. economy. I do know of economists within the administration who fervently believe that all will be well and that to argue to the contrary is tantamount to saying we need the same kind of steelmaking capability that we required in 1950, or that the United States should be entirely self-sufficient in every kind of product that is necessary for our national defense.

I don't make that case. I do, however, believe that what is essential is an industrial base, that our industrial base has been substantially weakened—not merely "altered" in the course of recent years, and there thus has been an erosion of our competence to support our international obligations from this domestic base.

I think that there could be some structural reform in an organizational sense within the Government. I recall 10 years ago having played a small part in a recommendation that the Secretary of the Treasury become a statutory member of the National Security Council. That was rejected, largely because the incumbents at the time on the National Security Council did not believe it was necessary. I am pleased that there has been created an Economic Policy Council, chaired by the Secretary of the Treasury, but I have some suspicions that it is not treated with the same kind of seriousness that NSC matters are, either in terms of attendance or in terms of the issues which are deliberated.

I believe that before the administration, this or any administration, makes decisions on manufacturing offset arrangements with foreign manufacturers for defense weapons systems or enters into coproduction agreements with our allies, or urges U.S. domestic defense contractors to concede a little more in providing for offset arrangements, I believe that these issues should be deliberated by a group which includes people who are the economic experts as well as national security experts.

I believe that it is important for the Congress to realize that not much can be done in the immediate future for our trade position, even through the strongest possible enforcement of our trade laws, even if they are tinkered with to make them more amenable to domestic producers, or even through opening up foreign markets.

I argued for 4½ years to the contrary, I realize, but now that the deficit has become so large, no matter what we do in terms of market opening measures, or trade law enforcement, we will not make a substantial difference.

I do not, in any sense, however, believe that we should relax enforcement or that we should avoid negotiating market opening measures, or that we should not have a strong commitment to the GATT negotiations, but I believe that reality should temper the expectations, because those expectations are likely to be large and they should be small.

I believe that a new look is warranted at our export control system, which I would characterize as a 35-year-old dinosaur. Any any time someone says that, there is usually an outcry from predictable quarters to the effect that anyone who recommends a liberalization in natural security controls is doing so motivated by crass commercialism. But gentlemen, that is not my motivation. The control list has grown beyond almost imagination, beyond counting. No one knows exactly how many items are on the embargo list. It is well over 100,000, and it has been a list constructed at a time prior to the pervasive availability of relatively sophisticated technology.

One can go into a retail store in thousands of stores in hundreds of cities—I would call them "high tech boutiques"—without any questions and with a credit card or cash, you can buy the latest state of the art microchip, not one, but a small barrelful of 'em.

And probably with a little suasion, you might even get a little technology in written form rather than product form.

If the administration itself is simply urged to make such reforms, and there are indications of some movement in that direction now, it is not adequate, in my opinion, because there are too many competing and conflicting interests within the administration. I think that the Congress and the administration and the private sector must work together or the kind of dramatic change which I believe necessary will not result.

Two final comments. One on the United States-Japan relationship. I was very encouraged when in December 1986, the Japanese Government endorsed publicly the recommendations in a report known as the "Maekawa report" by the retired chairman of the Bank of Japan. It was a most sweeping analysis on the nature of the Japanese economy and the direction that these Japanese luminaries believed it should go. Most important, it urged reducing, if not eliminating the reliance of the Japanese on an export-driven economy, and second, it urged major increase in the standard of living for the average Japanese citizen.

Those recommendations were stated in a very declarative way in December 1986, and I happened to have been in Japan just this past June 1986, when the interim report was issued, and it was in flat contradiction to the original. What had been stated as declarative recommendations are now characterized as mere items for further study.

The report had such dramatic overtones, that there was an objection of substantial proportions from the private sector in Japan. There are political forces in Japan who realize this is a good thing to do, not only for Japan itself, which is, of course, most important from their point of view, but that it would also make a large contribution to alleviating the international pressures that Japan feels.

So I am sort of discouraged that the Maekawa report which, when it first came out was greeted with great applause by the administration and by some in Congress, has really dropped out of sight. The administration seemed to have lost sight of it, as well as the Japanese, and I dare say many will look at it as another cynical contribution from Japan without real substance. I think that there should be an effort to hold the Japanese feet to the fire on implementation of that report.

Finally, Mr. Chairman, a lot has been said recently, and the media seems to lap it up, that American management is incompetent, risk averse, and unimaginative. I don't believe that. I believe that the track record would demonstrate clearly that American management has done what has been necessary to survive. And once again, one need only look at the balance sheets of the major corporations of America, and we will find that they have been doing pretty well, but they have had to undertake some rather dramatic and unconventional steps in order to remain profitable. I think that our problems stem, by and large, from macroeconomic forces which are not within the power of the private sector to correct, but clearly are within the realm of government, both the Congress and the administration, to make a large contribution toward resolving.

Thank you very much.

[The prepared statement of Mr. Olmer, together with an attachment, follows:]

PREPARED STATEMENT OF LIONEL H. OLMER

I've been asked to help the Committee develop information with which to evaluate the Economic Report of the President; to provide my observations regarding the "major international trade and international policy problems facing the country in 1987;" and to suggest changes in policies which I believe may be warranted.

Mr. Chairman, your invitation is a hunting license of intimidating proportions! By experience and background, however, I am ill suited to present the Committee with an elaborate economic analysis of where we are and wither we are tending. Happily for the analytic process, trade and investment data are not in short supply. I therefore do not propose to recite the numbers or to clutter the Committee's reading files with statistics that are now so bad in relative and absolute terms that no amount of manipulation could present them convincingly in favorable terms. I would hope, instead, to provide a few insights to the significance of the deficits and debt burden as I see it; to encourage a discussion on what I judge to be the most pressing issues; and to suggest areas which might be acted upon legislatively.

I offer as my potential contribution to these proceedings, comments on a few matters that I do know something about and about which I believe some things can be done if the Congress and the Administration will work cooperatively towards advancing our national interests.

Perhaps the best thing that can be said of the nation's current international economic condition is that, finally, at long last, everyone in government seems to accept the fact that we are confronting a very serious problem and that unless we reverse current trends and begin to bring into balance our trade accounts, a major crisis is unavoidable.

But while there is agreement that the staggering deficits and the foreign debt which promises to rise by the end of this decade to malignant proportions are not tenable conditions, I am unconvinced that there is a full appreciation of the impact and implications for American industry and to our national security.

I believe that the most serious consequence of the trade deficit is that U.S. business has been abandoning domestic manufacturing and is relying increasingly on foreign components with which to assemble final products. Although many U.S. corporations remain highly profitable -- on their balance sheets -- they have dramatically altered their ways of conducting business and in certain respects these "survival strategies" may not be in the best interests of America. For in my opinion, because of reasons which go to the heart of our responsibilities as the leader of the Western world, this country must have a solid base of industrial production. We need the enduring capacity to build things in America, not merely to provide services. And we need to advance, not merely to maintain, the ability to develop, innovate and apply new technology which is second to none. Of course, these "needs" are not mere academic abstractions. Manufacturing capacity which is eliminated is almost always accompanied by a loss of employment. And although the "great American job machine" is the envy of the rest of the world, properly so, success in creating new employment in the services economy is not a substitute for a healthy manufacturing sector. Moreover, it is manufacturing which underpins the creation of many service jobs. We cannot afford to become detached from our manufacturing competence and our heritage for innovation, except at the cost of a drastically lowered standard of living and the prospective incapacity to meet our worldwide security obligations.

Earlier I said that there seems to be acceptance among policy makers of our serious economic problems. But I do not yet detect a consensus that we absolutely require a healthy manufacturing community; nor that our trade performance in recent years is in significant measure a reflection of the decline in domestic production and employment; or even that our lead in technology is being eroded at an alarming rate.

Mr. Chairman, this lack of consensus as to what America needs for its own national interests, as well as to fulfill its international commitments, this failure to recognize or unwillingness to accept just how vulnerable we have become, is perhaps the worst that can be said of our present economic dilemma.

The attention being paid by government officials, the private sector and the media to the latest buzzword "competitiveness" is a good thing and the coming months will likely produce serious debate on a variety of proposals. I would argue that the underlying premise, however, should be the necessity for a strong U.S. manufacturing and technological base, and not merely maintenance of the profitability of U.S. multinational corporations in whatever manner they choose to be structured. The environment must be created -- and soon -- that will return manufacturing to this country from the offshore sites to which it has been deployed.

The movement offshore by U.S. manufacturers and their increasing reliance on foreign sourcing of component parts must not be misinterpreted as being a reflection of incompetent management: these relocations have been motivated principally by economic necessity; largely the over-strong dollar which precipitated the deluge of foreign imports and secondarily as a strategy to penetrate foreign markets not otherwise readily accessible.

Some analysts will argue that even though U.S. manufacturing has suffered in recent years as the deficit in manufactures trade has ballooned, "not to worry," -- they would say, "it is inevitable that the U.S. will be a manufacturing nation." These economists assert that present problems are of a transitory nature and that sooner or later "accounts will balance because they must balance." Perhaps. But in my view, the period of transition may cause such long term damage that the fundamental character of America's industrial base will be altered whether we want or intend it to and without regard to our national security interests.

In arguing for the maintenance of a strong, domestic industrial base, I am aware that the standard criticism of this proposition is that structural change is another "inevitable" economic fact of life driven by the law of comparative advantage, and that "we" must make room for new and more efficient competition from developing nations. Of course, it is true that economies must change, perhaps even drastically and in relatively short periods. But what has occurred in the last 15 years to U.S. industry, accelerated during the past 5 years, is not fairly captured by the euphemism "industrial restructuring." For example, there has been a decline in production workers in America's basic industries ranging between 50% to 75%; market penetration by foreign suppliers in many more higher value-added, defense related sectors ranges between 40% to 90%. The roots of our economic base have been shaken and the cost in human capital has been immense.

The Administration's proposal to reorganize Trade Adjustment Assistance, placing responsibility for both worker retraining and aid to individual firms entirely in the Department of Labor, and the budget proposal of $900 million for this program, represent an excellent, credible approach to many of these problems and I hope that swift approval by the Congress results.

It would appear that when the turn-around in the U.S. trade account begins to take place, it will have to result from changes in the manufacturing sector. This fact can be seen in a simple chart of the merchandise trade balance between 1985 and 1986; "manufactures" is the only category large enough to make the necessary difference.

Merchandise Trade Account ($ billions)

	1985	1986
Manufactures	-107	-140
Agriculture	+ 8	+ 3
Mineral Fuels	- 45	- 32
Other	3	2
Total	-163	-177

The Current Account incorporates the additional category of "income from overseas investments," which in 1985 posted a surplus of nearly $25 billion. But this surplus will "inevitably" decline as U.S. foreign debt increases, as U.S. interest payments on this debt increase and as the income derived from foreign investment in the U.S. (which must be paid abroad) also increases.

What can be done to hasten the turnaround? As I noted at the outset of my remarks, the divinings of the dismal science escape me. Surely, early steps in the right direction include a reduction in our dependence on foreign capital to finance U.S. deficits; a more serious effort to reduce our federal budget deficit; legislative incentives which will lead to increases in productivity; and a stabilization of the dollar exchange rate at a lower level than it is at present.

However, I'd like to concentrate my remarks elsewhere on what I believe can be done quickly and, equally important, point out a few areas where, even though actions will be helpful, we should not be misled into believing that they will make a significant, immediate difference.

First, we need a measure of organizational reform in the analytic and decision making processes of the Executive, principally in order to assure an adequate integration of economic, political and military considerations. For example, a determination by the Pentagon to increase its purchase of foreign products; or to pressure U.S. defense contractors to accept "off-set" arrangements with foreign manufacturers; or to co-produce military hardware, are major policy issues which should not be undertaken without the most careful examination of the impact on the entire U.S. manufacturing base. Similarly, a desire to achieve political harmony (or, to avoid unpleasantries) with foreign nations should not become the dispositive reason for failing to protect a domestic industry which has been injured by imports. The Administration's creation of a cabinet-level Economic Policy Council chaired by the Secretary of the Treasury is a good idea; but I'd be curious as to whether attendance at EPC meetings reflects the same kind of seriousness evident at National Security Council meetings where cabinet principals almost always are present. About ten years ago, Congress proposed adding the Secretary of the Treasury as a statutory member of the NSC, but the idea was rejected by the Executive. I believe it should be reconsidered.

Second, we should not hope for a large and favorable impact on the trade deficit merely by vigorous enforcement of our trade laws, nor as a consequence of the pursuit of a new round of negotiations under the General Agreement on Tariffs and Trade. The size and content of our deficit has overwhelmed the contribution which might be made solely as a result of time-consuming bilateral and multilateral efforts to open markets (even if they are successful experience has shown that success in negotiations does not necessarily lead to increased sales). In saying this, however, I must add that I support fully the Administration's actions in these respects. The pursuit of fair trade can and will make a difference, especially in the longer term and particularly -- even in the short run -- to individual companies and industrial sectors. Some (but not much) tinkering with U.S. antidumping and countervailing duty laws will also be helpful, but great care must be taken not to "overload" the system of administering these laws. They are enormously complicated and require highly skilled, motivated analysts with good judgment. Kept in a pressure cooker without adequate relief for too long, subject them to political suasion as might be implied from aggressive challenges to their determinations, and there would be a risk of collapse and loss of credibility of the system -- to no one's benefit.

Third, we should eliminate unnecessary restraints on the export of U.S. products and technology, particularly where such restraints are irrelevant to the achievement of U.S. foreign policy or national security objectives. It is urgent that the list of embargoed, national security products (numbering more than 100,000 items) be reduced in recognition of the dramatic changes over the past 15 years, during which the availability of relatively sophisticated technology has become pervasive. State-of-the- art electronics can be bought with no questions asked for cash or credit in thousands of high tech boutiques from Hong Kong to Singapore, Sao

Paulo to Vienna and in every major city in Europe, Japan and the U.S. Today, as a consequence of the export control system, U.S. companies are losing business without any offsetting advantage to security interests. Although there appears to be movement within the Administration to reform the export control system, I despair of major changes unless the Congress, the private sector and the Administration work together. I strongly support a special effort to reexamine the premises on which the export control system is based, redefining the meaning of "strategic" products and technologies and streamlining the system's management. Because I do not believe that dramatic change will result if this kind of effort is left exclusively to the Executive, I suggest creating a "blue ribbon" panel of experts appointed by both the Executive and Legislative branches from candidates in universities, government laboratories and the business community.

Mr. Chairman, nearly as soon as one calls for change in strategic controls, an outburst from certain quarters can be expected charging that "reform" is a subterfuge for crass commercialism at the expense of our national security. I think the opposite is true: the more we sharpen the focus of our controls by eliminating the extraneous, the better our chances will be of impeding the flow to our adversaries of the fruits of Western technology.

Fourth, a word about the U.S.-Japan relationship and the huge trade deficit we have been experiencing ($50 billion in 1985, $60 billion in 1986 and perhaps $70 billion in 1987). This bilateral deficit is not a tolerable situation and the numbers desperately need to come down, drastically. Although major reductions will not happen merely by Japan increasing its imports of U.S. manufactured products, that approach would be one way for the Japanese government and industry to demonstrate an understanding of the seriousness of the situation and of the dire consequences which will follow in the absence of improvements. Unhappily, I do not yet detect a sufficiently widespread recognition in Japan that would foster this tactic. I might add that the Maekawa Report of last April, which was a major affirmative sign from Tokyo that change was on the way, met with immediate applause in high government circles on both sides of the Pacific; but it has quickly dropped from sight and sound. Indeed, the interim report of "accomplishments" which was issued in December, observes (in flat contradiction to the original conclusions) that the recommendations were not intended as measures for implementation but were merely items to be further studied.

The Maekawa Report holds the prospect of fundamentally altering the character of the Japanese economy through:

- -- eliminating its dependence on export-led growth;
- -- reducing quite rapidly the capacity of inefficient domestic industries, relying instead on imports;
- -- encouraging people to work less hard, save less money; and
- -- seeking major improvements in the quality of life for the Japanese citizen.

Mr. Chairman, many of the themes that I've commented on today were covered in detail -- with statistical backup -- in a report which I submitted to the Secretary of Commerce in June 1985 when I left government service. It is entitled U.S. Manufacturing at a Crossroads: Surviving and Prospering in a More Competitive Global Economy. This report analyzed the alarming trend evident nearly two years ago in the movement offshore of U.S. companies unable to compete at home, and the risk to our national interests if the trend were to continue. I offered no magic solutions (although I did argue that the U.S. dollar would have to come down in value rapidly and substantially). But the report concluded that the Government's role must be to create a positive environment leading to more efficient use of labor and capital, and to remove both domestic and foreign obstacles which inhibit industrial competitiveness. I would like to make available a copy of this report as an appendix to my testimony.

Finally Mr. Chairman, just as I would urge that the Committee not place undue weight for the correction of our trade deficits on trade remedies, I also feel obliged to take issue with those who would assign major responsibility for contemporary business conditions on poor U.S. management or so-called "corpocracy". The reality of U.S. corporate performance up to 1981 (when we had a current account surplus!) and to a large extent even today, does not support the judgment that American management is "bloated, risk averse, inefficient and unimaginative." Individual companies have performed quite well -- taking risks in investing abroad because they could not compete with a strong dollar at home. Moreover, venture capital is available in the U.S. as it is nowhere else in the world; U.S. graduate schools in science and technology continue to attract foreign students who have no adequate alternatives; and the business track record of foreign- based subsidiaries of U.S. corporations is first rate. Our largest problems are not the creation of American management or labor; they are the result of macro-economic forces beyond the control of the private sector but clearly, to a very great extent, within the power of government to correct.

Thank you for the opportunity to testify.

U.S. MANUFACTURING AT A CROSSROADS

Surviving and Prospering in a More Competitive Global Economy

A REPORT BY LIONEL H. OLMER
UNDER SECRETARY FOR INTERNATIONAL TRADE
JUNE 14, 1985

U.S. DEPARTMENT OF COMMERCE International Trade Administration

UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for International Trade
Washington, D.C. 20230

June 14, 1985
Honorable Malcolm Baldrige
Secretary of Commerce

Dear Mr. Secretary,

Several months ago when we first discussed my preparing an "end-of-tour" report for broad dissemination in and out of government, the potential for erosion of our domestic base of manufacturing seemed but one of many important topics and trends which I might cover in reflecting on four and a half years as Under Secretary for International Trade.

I have come to believe that this issue should be of overriding concern.

The intervening period proximate to my departure has produced an accumulation of evidence that our country is fast approaching a watershed in this regard, with enormous consequences for our economic health, for our objectives in promoting further liberalization in the world trading system, and for our larger national security interests.

Thus, this report is devoted to an examination of that prospect and its policy implications.

It has been a privilege beyond measure to have served.

Respectfully yours,

Lionel H. Olmer

U.S. MANUFACTURING AT A CROSSROADS

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Key Conclusions

In the Near Term

U.S. manufacturing stands at a crossroads.

If the dollar remains near present strong levels for another year or two, the erosion that has already started in the breadth and depth of the U.S. manufacturing base will worsen seriously—a situation most difficult to reverse.

- The strong dollar is forcing many U.S. firms to buy more goods abroad. Many more companies are moving production facilities overseas and leaning more heavily on the licensing of their technology and on mergers and joint ventures with foreign companies. In essence, U.S. companies are reducing their reliance on export-oriented strategies.

If, however, the dollar soon returns to a more realistic level the stage would be set for a sharp rebound in the U.S. competitive position in world markets.

- U.S. manufacturers have been spending considerable resources on modernizing their production processes and are beginning to achieve significant productivity gains.

For the Longer Run

Even after the dollar declines to a more reasonable level, U.S. manufacturing will face tougher and more effective competition than ever before.

- The stiffest challenge will come from the Pacific Basin, in particular as the Japanese seek additional markets as a part of their export drive, and as the newly industrializing Asian countries move into increasingly sophisticated products.
- A number of other developing countries also are improving their manufacturing capabilities.
- Europe is beginning to reorganize its industrial base and may begin seriously to challenge U.S. industries in additional product lines. To gain a foothold, one can expect them to make aggressive use of government subsidies in many forms.

Meanwhile, all societies will face even more wrenching strains in adjusting to industrial change than they have experienced in the past 15 years.

- With the microelectronic revolution spreading into all industries and other new high technology industries gaining momentum, the global production structure will remain in ferment.
- Product lifecycles in many of these new industries will often be less than three years, compared with more than ten years in some of the traditional "smokestack" industries.
- Companies able to adopt new technologies efficiently will periodically leapfrog their competitors and capture (or recapture) important growth markets almost overnight.

What This Means

To survive and prosper in an increasingly competitive global economy, it is essential that

- The dollar decline in value, and soon, an accomplishment easier to express than to effect, but one clearly requiring a major reduction in federal budget deficits.
- We work to enhance those fundamental strengths—the ingenuity, vitality, and flexibility of our entrepreneurs and workers—that have enabled us to adjust to changing trade and industrial patterns in the past.

- We accelerate actions to minimize the impediments to mobility of capital, know-how, and labor; in other words, apart from dollar-related issues, we should implement a strategy that encourages American business to produce and export from America.
- We diligently press other nations to make their markets as open as ours.
- We avoid tempting, but self-defeating, protectionist actions that would only insulate us—temporarily and unsuccessfully—from the forces of global competition.

Lionel H. Olmer
June 14, 1985

Introduction

There has been a resurgence in the U.S. economy since 1981 which has been the envy of much of the world. Crippling inflation and unprecedented high interest rates were dramatically reduced and the United States pulled out of a recession caused by these distortions. The economic rebound is the strongest in our postwar history and it has outpaced recoveries in all other major industrial countries. New employment in the United States has risen to record highs, while job creation in other industrial countries has stagnated. In addition, growth in investment and research and development expenditures by U.S. industry has reached rates not seen since the 1950s.

At the same time, the vitality of our domestic economy has made us a magnet for foreign investment and imports. This, coupled with a dollar that has remained too high for four years, has caused the U.S. merchandise trade deficit to rise to unprecedented heights. The key element of this worsening trade position was a staggering $92 billion slippage in our manufactures balance from 1981 to 1984. The situation continues to deteriorate. The manufactures trade deficit for first quarter 1985 was almost one-fourth larger than for the same period in 1984.

These huge merchandise trade deficits and the prospect of continued large deficits have generated great concern about the present U.S. ability to compete in international markets and the longer term viability of our U.S. domestic-based manufacturing. There is widespread alarm that the strength of the dollar and other factors are increasingly forcing U.S. firms to move their production abroad or to buy from foreign suppliers. Some observers cry out that these shifts are "deindustrializing" the United States, with the prospect of serious damage to the U.S. economy, to much of our industrial base, and to our broader national security interests.

In the last four and one-half years as Under Secretary for International Trade in the Department of Commerce I have learned first-hand about the concerns, problems, and achievements of hundreds of U.S. and foreign firms. My assignment has also given me a perspective on how international trade influences the well-being of all U.S. citizens, our national security, and the interactions between U.S. interests and those of our major trading partners. I have benefitted greatly from the insights of officials from other governments equally committed to free markets as well as from those whose economies are centrally controlled or where government intervention is significant.

I believe that certain insights and judgments should be shared. I feel it is particularly important to state the conclusions drawn from my experience because I sense that the United States is at a crossroads, where events now unfolding will determine the competitive status of many U.S. industries for years to come and, given the importance of international trade, the ability to fill our leadership responsibilities in the world community.

The problems we face in international trade are very complex, with no simple answers. Indeed, it is often difficult to obtain agreement on a definition of some problems, let alone achieve consensus on solutions. Reaching consensus is often especially difficult in our pluralistic and democratic society, because developments which benefit one group are frequently seen as detrimental to another.

Moreover, U.S. manufacturing is incredibly diverse, ranging from cosmetics to computers, steel to synthetic yarn, automobiles to appliances, and plastics to photocopiers. Some U.S. manufacturing industries remain relatively unaffected by foreign competititon; others bear the brunt of an increasing foreign presence in U.S. domestic and export markets. In some industries, there has not been significant pressure for change; in others, both products and manufacturing processes are changing rapidly to meet foreign competition.

In such an environment, I realize that my conclusions may be controversial and perhaps challenged on grounds of insufficient evidence. In this report, however, I include data from many sources and draw on discussions with a wide range of individuals and groups from a broad spectrum of American industry, international business, and foreign governments. My assessment is intended to deal with the overall impact on the U.S. economy and on our larger national security interests.

ORGANIZATION OF THE REPORT

In Part I of my report, I stress two key problems:

- *The increasingly stunning impact of the strong dollar on the U.S. industrial base.* I believe the strong dollar has positioned U.S. industry at an important crossroads and that the behavior of the dollar over the next two years will have a decisive effect on the U.S. industrial base for years to come.
- *The more enduring industrial trade issues that we must cope with no matter what the course of the dollar.* I emphasize the continuing and painful process of industrial adjustment; the need to open Japan's markets; the growing competitive power of the newly industrializing countries, particularly that of the Pacific Basin countries; and trade problems resulting from the Latin American debt crisis.

Part II of the report provides a more detailed analysis of the changing U.S. international trade position in manufactures and puts into perspective—historical and future—the issues described in Part I.

PART I
KEY PROBLEMS AND THEIR IMPLICATIONS

U.S. MANUFACTURING AT A CROSSROADS

Each day the evidence becomes clearer that the normal pace of change in U.S. international trade patterns is being accelerated and distorted by a dollar that has remained too strong for too long. A strong dollar raises the price of U.S. exports and lowers the cost of U.S. imports. To stay competitive in the U.S. and international markets, many U.S. firms are taking steps they would not have taken had the dollar better aligned U.S. manufacturing costs with those of Japan and Western Europe. Many U.S. firms are increasing their reliance on foreign manufactured components. Many others are now contemplating decisions to move their manufacturing operations overseas. And some U.S. companies are dropping product lines, or are turning to licensing or production overseas as a less preferred but necessary alternative to exporting, even though until recent times they had been quite successful in international markets. At the same time, however, many U.S. companies are investing new capital to make their domestic production processes more efficient.

As a result of recent and impending decisions concerning overseas procurement and the transfer of manufacturing facilities abroad, I believe that much of U.S. industry now is poised between what may be a significant further weakening or what could be a major resurgence in our international competitiveness.

In what follows in this section, I briefly review the role of the strong dollar in declining U.S. international competitiveness, how U.S. firms have attempted to meet the challenge, and my perception of the important role of the dollar exchange rate in determining the strength and breadth of the U.S. industrial base in the precarious period ahead.

The Growing U.S. Competitiveness Problem

The growing loss of competitiveness in international markets is dramatically illustrated by the following trade trends.

- The U.S. trade balance in manufactures has moved from a surplus of $11 billion in 1981 to a deficit of $81 billion in 1984, a swing of $92 billion in only three years.
- The manufactures trade deficit in 1984 reached an unprecedented 10 percent of the value of manufacturing output; before the 1980s the highest deficit share was 2 percent (see figure 1).
- The volume of U.S. exports in manufactures in 1984 was 14 percent below the 1981 level; manufactures imports climbed an astonishing 53 percent over the same period (see figure 2).

Figure 1

U.S. MANUFACTURES TRADE BALANCE AS A SHARE OF MANUFACTURING OUTPUT, 1970-84

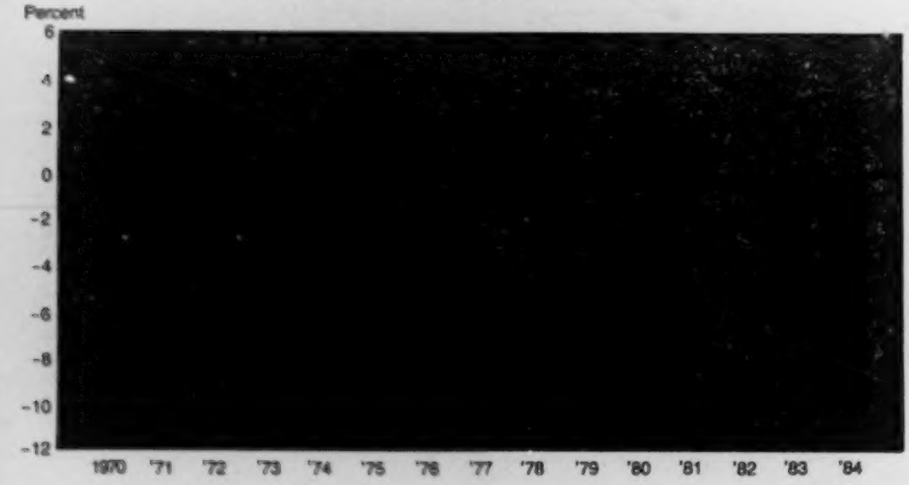
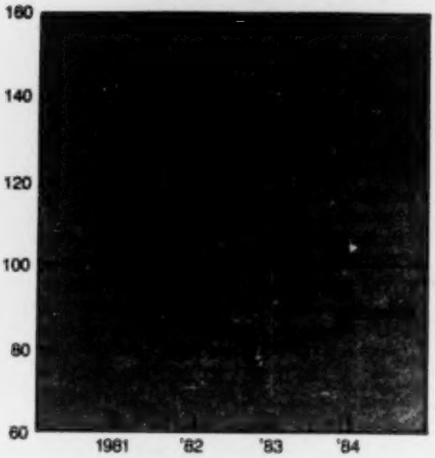


Figure 2

U.S. MANUFACTURES TRADE VOLUME, 1981-84

(Index: 1981 = 100)



The dollar's value clearly contributed most to our manufactures trade deterioration. It has been overly strong against the yen and most European currencies for four years. In recent months its value vis-a-vis these currencies, after adjusting for differences in domestic inflation rates, has been as high as during the early 1970s, when trade problems first emerged as a major factor influencing the well-being of the United States. Estimates of how much the dollar has contributed to our deteriorating trade position vary from one-third to two-thirds; because of different time periods used and the impossibility of clearly isolating the effects of the dollar from other factors, no precise calculation is available. I believe a reasonable estimate would be that the dollar has accounted for more than half of our worsening manufactures trade balance between 1981 and 1984.

Other factors that were also important include:

- Domestic demand rose much faster in the United States than in Western Europe and Japan.
- Latin American purchases of foreign goods plummeted as a result of their debt crises. U.S. sales of capital goods were especially hard hit. Simultaneously, Latin American exports to the United States rose sharply as those countries tried to overcome foreign exchange constraints and meet the "conditionality" terms set by the International Monetary Fund. As a result, the worsening in the U.S. trade balance in manufactures with Latin America was even greater than with Japan.
- Some foreign countries—especially the newly industrializing countries (NICs)—placed new or increased restrictions on the imports of high technology products of which they are trying to start up production. Often these are products in which the United States has a competitive edge.

Until recently the adverse effects of the dollar and other factors have been masked by the powerful U.S. economic recovery. In fact, the recent trade deficits have had some benefits for the United States. Had it not been for the jump in imports, the substantial increase of U.S. output would not have been possible without a new spurt in inflation. The robust U.S. economy, along with foreign fears of U.S. protectionist actions, have resulted in sizable foreign investments in manufacturing in the United States. This has helped boost our economic expansion.

Meanwhile, although concerns have grown over the impact of the strong dollar on our trade balance and on certain industries, they have been somewhat muted by the many favorable economic trends, especially the enormous resurgence in the U.S. economy and confidence in our country. Indeed, many companies earned record profits and total U.S. employment increased sharply, reaching new records, even though employment in manufacturing has not returned to the 1979 level.

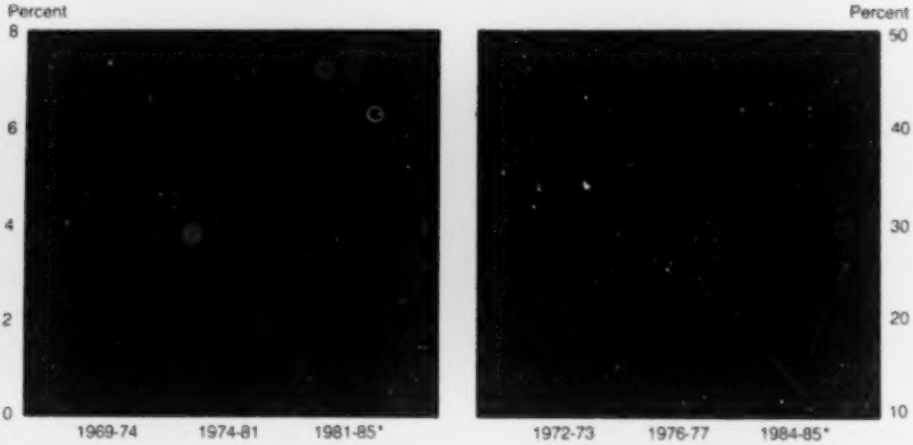
Despite increasing import penetration, manufacturing output also rose considerably in recent years. By 1984, output stood 8 percent above the previous high in 1979. But defense production, which is hardly affected by foreign competition, has accounted for more than 40 percent of the increase in manufacturing output since 1979. Nondefense output has been relatively weak, rising less than one percent per year from 1979 to 1984, compared with 3.5 percent annually from 1973 to 1979.

Meeting the Competitive Challenge

U.S. manufacturing firms have attempted to meet the increased competitive challenge from abroad mainly by investing more in improving the efficiency of their domestic production processes and by procuring more foreign goods. Investment in domestic manufacturing equipment has risen particularly sharply during this upturn (see figure 3). Moreover, this strong investment spending began from a relatively high recessionary base. Mainly as a result of increased investment, output per worker in manufacturing rose nearly twice as

Figure 3

REAL GROWTH IN U.S. INVESTMENT IN MANUFACTURING DURING PAST THREE BUSINESS CYCLES



*Expected based on survey

fast from 1979 to 1984 as it did from 1973 to 1979. Ironically, however, this domestic manufacturing equipment investment boom stimulated a dramatic rise in imports of foreign machinery, thereby blunting the job-creating effects of investment.

Meanwhile, many U.S. companies are also increasing their reliance on less expensive foreign components and parts in the effort to remain competitive. Many U.S. companies already had well established linkages with foreign suppliers or could easily forge new ones. The newly industrializing countries (NICs)* have been especially aggressive in supplying U.S. needs through assertive marketing and a great willingness to show how quickly and effectively they could respond to new orders. In fact, the value of manufactures imports from the NICs between 1981 and 1984 rose by more than two-thirds.

Decisions to invest in new production facilities abroad or to accelerate earlier plans to move overseas have developed more slowly. Some U.S. firms that had significant excess production capacity in Europe found that the best means of meeting competition was to increase output in these existing plants and ship the products to the United States and to third country markets. More importantly, decisions to move production facilities abroad involve long-term strategies which often take considerable time to change. In establishing plants abroad, U.S. companies must consider many issues. They often find such investments are the only way to achieve a market presence in a country because of import barriers or pressure from a foreign government that has the power to prevent entry. Investment incentives provided by foreign governments may play a role in their decisions. Thus, the value of the dollar is only one among many reasons for moving abroad, although recently the most decisive one.

Problems Intensify

A growing body of evidence indicates that the impact of the strong dollar has deepened considerably since mid-1984.

- U.S. manufacturing output and employment have stagnated, although the rest of the economy has continued to grow.
- Imports as a share of U.S. consumption of manufactures jumped two percentage points in 1984, an increase that tops any previous annual rise and is equivalent to the entire such rise in import penetration in the 1970s. Import penetration continues to rise in 1985.
- The movement of U.S. manufacturing plants abroad is accelerating. A Department of Commerce December 1984 survey indicates that U.S. companies plan to increase investments in manufacturing of their foreign affiliates by 22 percent in 1985. This compares with a 6 percent rise in 1984.

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* Hong Kong, South Korea, Singapore, Taiwan, Brazil, and Mexico

Although comprehensive statistics are not available, my discussions with numerous U.S. businessmen and reports from the research community provide further evidence that the accumulating effects of enduring dollar strength are forcing U.S. companies to new strategies to ensure long-term competitiveness:

- Many U.S. companies are now basing their planning on the assumption that the dollar will remain strong for some time, while in 1984 their strategic planning often assumed the dollar would soon fall.
- More and more, U.S. manufacturers are reducing or ending production of a number of least profitable products they had been making in the United States, turning to foreign suppliers to maintain a full product line.
- Increasingly, U.S. exporters are reducing or contemplating closing marketing and servicing operations abroad because of limited sales.
- Foreign manufacturers and traders are expanding sales and marketing operations in the United States and are developing long-term strategies for further penetrating U.S. markets. The number of inquiries made to U.S. importers and consulting firms about exploiting the U.S. market also is rising substantially.
- More U.S. companies are exploring the increased use of licensing of technology, joint ventures, and mergers in key markets in lieu of more export-related strategies. For example, an unpublished survey indicates that two-thirds of a group of major U.S. firms engaged in international business are now licensing their technology overseas, compared with only one-tenth a few years ago.

Precarious Period Ahead

In my judgment, we are thus entering a precarious period. On balance, U.S. industry has fared well in the past few years, but the future is filled with uncertainty and potential hazards. Much depends on the path of the dollar. Although the dollar has weakened somewhat in recent months, it remains excessively high in terms of U.S. international trade performance. If the dollar does not fall much further, many more U.S. firms will feel it necessary to take additional steps to cope with their price disadvantage, especially against goods from Europe and Japan. Meanwhile, if the U.S. economy continues to slacken, U.S. firms will find themselves attempting to compete for shrinking domestic markets against foreign companies that have in recent years devoted considerable energies to building up a market presence in this country. Because of the dollar's effect on exports, U.S. firms have become dependent on domestic sales during the economic recovery. They will therefore be particularly hard hit in any downturn. In addition, with much of recent foreign economic growth based on selling goods to the United States, rather than on sales in their home markets, economic expansion abroad could suffer, further depressing U.S. exports.

In this situation of continued dollar strength and a slowing U.S. economy, some U.S. companies that have invested considerable resources to become more efficient will be under strong financial pressures and many more will feel discouraged by a continued lack of competitiveness despite all their efforts. We would thus undercut the immense achievements of the Reagan Administration and what I believe is America's great strength—the initiative and vitality of entrepreneurs. Along with waning confidence in the efficacy of U.S. industry, the movement abroad of production and procurement would accelerate, including manufacturing activities that would be viable in the United States under more normal price competitive conditions. Under such circumstances, protectionist sentiments can be expected to rise and will be particularly difficult to contain.

In sharp contrast to this highly adverse possibility, the stage also is set for a rather sharp rebound in the U.S. competitive position in world markets and for an improvement in the manufacturing trade balance. Such a favorable outcome would occur if the U.S. economy continues to grow (even if at a slower pace than in 1983 and 1984), if economic activity picks up abroad, and, most especially, if the dollar moves downward.

Although cyclical economic downturns at some point are inevitable, the record of the 1960s and 1970s indicates the expansion phase could last five years or more, although there could be temporary slowdowns. We are now in the third year of the upturn.

Under conditions of a declining dollar and continuing economic growth at home and abroad, the new, more efficient industrial base now being put into place would begin to have substantial payoffs. Sales would be boosted and market share gains would occur. Confidence in domestic-based American manufacturing know-how would again be asserted in international markets. Export growth in manufactures would likely surpass import growth, helping to reduce the trade deficit. Strong investment in U.S. manufacturing would continue and our manufacturing base would continue to strengthen.

In addition, many U.S. firms, especially in dynamic high technology industries, would buy more of their needed components and parts from suppliers near their manufacturing plants rather than from those offshore. These U.S. producers prefer to have suppliers close at hand so they can more quickly alter their fast changing product lines, and the weaker dollar makes such a preference more feasible from a cost point of view. The result would be increased domestic output and curtailed imports.

I realize, of course, that neither outcome is probable in these clear-cut extremes; there is a broad spectrum of other possibilities between them. Moreover, individual U.S. industries differ in their exposure to foreign competition and their dependence on foreign markets. But I believe the chances are higher than at any other time in recent decades that the outcome may be close to one of these two alternatives.

Much will depend on global economic forces at work, especially the trends in the economies of the United States and other industrial countries, activities taken to reduce the U.S. budget deficit and interest rates. All these factors are intricately interwoven with the fate of the dollar. In Part II of this report under *"What Happens Next"* I discuss some of the plausible scenarios linking the dollar and other factors.

One aspect of the current problem, however, is crystal clear. The dollar must come down sooner or later. The only questions are "when, how fast, and how far?"

If the dollar *does not* begin its descent soon, our annual current account deficit may rise from the present level of near $100 billion to perhaps $200 billion in a few years. The deficit is now nearly 3 percent of U.S. gross national product (GNP) and could reach 5 percent in a few years if the dollar remains at lofty levels. Although times have changed, these shares top the previous 2 percent record in the 1870s, when the United States was industrializing and in the midst of a railroad building boom.

Financing these huge current account deficits would mean flooding the international financial markets with U.S. dollar assets. Such borrowings, in turn, could soon make the United States a larger net debtor than even the less developed countries (LDCs) as a group. At some point, within a few years, international investors would reduce the amount of new investment in U.S. dollar securities, even if interest rates jumped substantially and despite confidence in America as a safe haven. The dollar would then fall rapidly. A deep domestic recession could also bring down the dollar by reducing imports sharply and by undercutting investor confidence in the U.S. economy. We could also inflate our way out of the massive foreign debt. These solutions, however, would in my judgment, produce cures worse than the disease.

We can also expect an eventual deep dollar decline if our currency remains strong for many more years. Under these circumstances, by the late 1980s, achieving a manageable current account position will depend even more heavily than today on running a sizable trade surplus in manufactures. The U.S. trade surplus in agricultural goods cannot increase by much more and we will continue to run sizable deficits in imports of commodities, especially oil, that are not in adequate supply in the United States. Meanwhile, the rapidly rising interest payments on a huge and growing foreign debt would make the United States a net importer of services, rather than a net exporter, a position we held for decades.

Thus, if the U.S. current account balance is to turn positive again, our manufacturing trade balance must take up the slack and move from the present large deficit position to a very substantial surplus. But with our manufacturing base being fundamentally altered and eroded by a long-running strong dollar, the dollar decline would have to be especially deep in order to restore our competitiveness by enough to manage a surplus in manufactures large enough to overcome other negative balances in our current account. This could require a fall in the dollar to levels well below any experienced in recent history. While we now see significant problems from an overly strong dollar, a grossly weakened dollar would also impose costs on our economy, especially through a buildup in inflationary pressures.

There are additional reasons to stress the dangers of a continuing unduly strong dollar. With a diminishing manufacturing base, jobs would be unnecessarily transferred abroad. Moreover, as markets became awash in dollars the risk of an international financial crisis would grow. An eventual sharp decline in the dollar would add to the international financial woes and, as it did in the late 1970s, bring into question the vigor of the U.S. economy and pose greater challenges to our global leadership responsibilities.

THE DIFFICULT INDUSTRIAL ADJUSTMENT PROCESS

The overly strong dollar is an immediate problem that requires prompt action. But we must also recognize that no matter what the dollar's fate, U.S. industry will continue to change and evolve and we will continue to face enduring problems of industrial restructuring—the social and economic problems raised by the shedding or shrinking of employment and output in older, more mature industries and the increases in newer, more dynamic industries.

Foreign competition is playing an increasingly potent role in our industrial restructuring process. The share of imports in our domestic markets grows constantly while, until recently, an increasing share of our domestic production was being exported. Even after a decline in the dollar, we should expect that foreign manufacturing capabilities will continue to increase, resulting in increasing foreign competition both in the U.S. market and in other foreign markets. Foreign competition will be particularly tough in lower-technology, labor-intensive products where lower foreign wage levels provide a significant competitive advantage. But as foreign technological capabilities increase—as they clearly will in the next few years, especially in many Pacific Basin nations—few industries will be exempt from increasing foreign competition.

The problems of industrial restructuring are, therefore, not going to diminish. Rather, as technological change accelerates, our adjustment problems will multiply. Yet we cannot avoid the increasing pace of change and industrial adjustment if our economy is to grow and compete successfully in an international environment. Indeed, a major strength of the U.S. economy in recent years has been our ability to adapt more readily to change than many of our competitors.

While the process creates opportunities, it also often inflicts hardships. We must do what is possible to minimize the pain of the adjustment process in the declining older industries. But we must allow industrial restructuring to move ahead if we are going to continue to enjoy the benefits of an economy that can compete effectively at home and in global markets; industrial restructuring is a sign of economic strength rather than weakness. The burdens of this unfortunately painful process should not be inequitably felt by workers in one sector. And, of course, if we accept the necessity for wrenching change, we should expect no less from our trading partners who, unless forcefully persuaded otherwise, will export their restructuring costs to our markets.

Because the problems and pain of change are likely to be more immediately evident than the benefits, it is important that we have a clear picture of what has already occurred and what is likely in the future. In the remainder of this section I pose five frequently asked questions about industrial restructuring and provide my assessment of each.

Is the United States "Deindustrializing"? Is Our Manufacturing Base Eroding?

Most assuredly, no. At least, not so far.

There is much confusion about the state of our U.S. manufacturing base, often because the trends are misread. Those who use the term "deindustrialization" cannot mean that industry is declining in absolute terms because it is not. Industrial production continues to increase in the United States as new peaks in production have been reached during each new business cycle.

Others point to the decreasing share of manufacturing in GNP, as measured in each year's prices. It is true that the manufacturing share of GNP did drop from 29 percent in 1960 to 20 percent in 1984, with most of the decline occuring in the 1960s and since 1979. But this statistic is not conclusive. It does indicate (1) the growing preference of an increasingly affluent society for more services; and (2) the fact that prices in services rise faster than in manufacturing because service sector productivity rises slower than manufacturing productivity. When price changes are stripped away, we find that manufacturing output as a share of real GNP has remained rather constant—around 24 percent in 1972 dollars.

Employment also has been affected in a similar fashion. The increasing preference for services and the greater gains in productivity in manufacturing have resulted in the number of hourly workers in manufacturing plants slipping from 21 percent of civilian employment in 1960 to 13 percent in 1984. In absolute terms, however, the number of workers in manufacturing has not changed significantly since the mid-1950s, excluding, of course, short-term cyclical disturbances.

No major industrial country has experienced manufacturing job increases since 1973. Japan and the United States both had a slight drop in manufacturing employment between 1973 and 1984. In Western Europe, however, the number of jobs declined sharply—by nearly 20 percent in West Germany, for example (see figure 4). Manufacturing employment remained more stable in the United States, partly because of our greater emphasis on putting people to work rather than on productivity increases. For example, output per manhour in manufacturing rose about 45 percent in West Germany and 90 percent in Japan between 1973 and 1984, but only 25 percent in the United States.

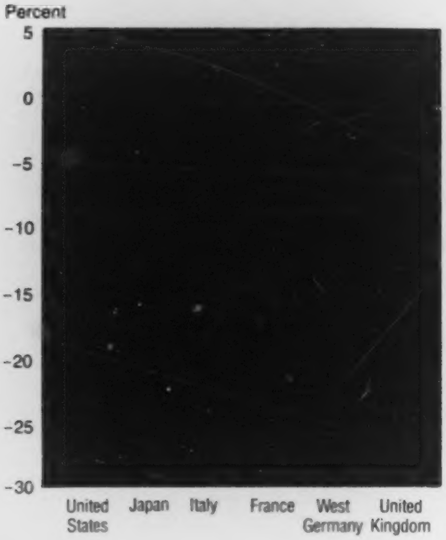
In U.S. agriculture, even more pronounced changes have taken place than in manufacturing. Yet no one would suggest we have an inefficient and weak farm sector. The agricultural labor force in the United States declined from 20 percent of our labor force in 1930 to less than 3 percent today, and the number of farm workers actually fell to about a third of the 1930 level. This does not mean we have "deagriculturalized". Agricultural output has more than doubled since 1930 and U.S. farming is widely considered to be the most efficient in the world.

If the United States Is Not "Deindustrializing" What Is Happening to U.S. industry?

Its form and composition is changing dramatically because of new technology, changing production techniques, shifts in consumer tastes, and, increasingly, foreign competition. Some older industries are shrinking, new industries are growing.

Figure 4

INDUSTRIAL COUNTRIES: TRENDS IN MANUFACTURING EMPLOYMENT, 1973-84



Although there are numerous influences forcing changes, apart from import penetration, the two most important are the shift from mechanical industries to microclecronics industries and from metal-based materials to synthetics, such as plastics. As can be seen from figure 5, the most dynamic increases have been in industrial categories, such as electronic components, communication equipment, office and computing machines, synthetic materials, and plastic products. On average, these industries grew some three times as fast as overall manufacturing output between 1973 and 1984. Moreover, currently available data substantially underestimate the growth of many of these industries, especially computers and microelectronics, because production indices have not taken into consideration the enormous quality improvements, for example in computing power, that have taken place in the past 20 years. The Federal Reserve Board has been examining this and shortly will release revised data on its industrial production series.

In sharp contrast to these rapidly growing industries, production is declining in others. The most notable shrinking industries include primary metals (both steel and nonferrous metals), fabricated metals, metalworking machinery, farm equipment, construction machinery, petroleum products, and basic chemicals.

The declines result from a wide mix of reasons that in several cases go well beyond technology changes. The agricultural equipment business has soured, in large measure because of financial and other troubles in the U.S. farm community as well as aggressive foreign competition. The decline in refined petroleum products stems from both the reduced demand for this form of energy because of high prices, and the increased shipments of oil in refined rather than crude form by major oil exporting nations. More oil producing countries are now exploiting significant potential comparative advantages in petroleum derivatives by moving into basic petrochemicals. This appears to be an irreversible trend. As a result, a number of U.S. chemical firms are concentrating on more sophisticated products.

The importance of foreign import penetration varies considerably for each sector, reflecting the highly diverse nature of our industrial base. Looking at twenty industries (figure 6), four industries which together account for about a quarter of manufacturing output face minimal foreign competition. On an output basis, two of these industries are growing faster than average—food and printing and publishing—while in the other two output in 1984 was less than in 1979.

In seven industry categories representing nearly 30 percent of total output, import penetration has reached from 5 to 10 percent of U.S. consumption. Again, the trends differ significantly, with above average output growth in rubber and plastics, furniture, and chemicals, and poor performance in stone, clay and glass, and petroleum.

Import penetration has reached the 10 to 20 percent range in five industries which combined account for more than 40 percent of total output. Output growth is again varied, with primary metals doing poorly and electrical machinery doing well.

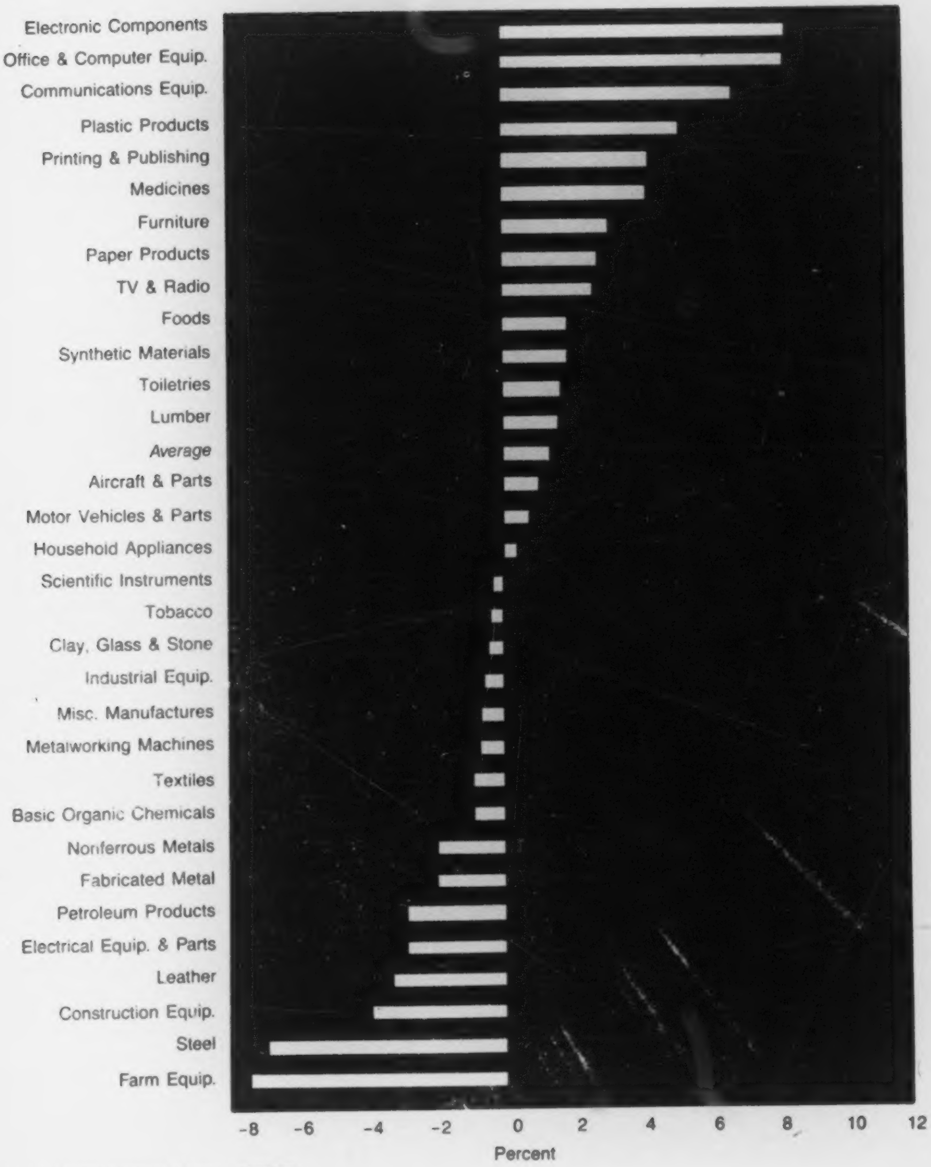
The categories where import penetration exceeded 20 percent in 1984—apparel, leather, and miscellaneous manufactures such as toys—account for about 5 percent of total U.S. output and, in all cases, the output of these sectors declined between 1979 and 1984.

I realize that these data hide many differences among individual product lines. For example, although the overall import penetration rate in food products is a low 4 percent, there are many individual food products—for example, wines and crackers—where foreign penetration is high and growing. At the other extreme, within the miscellaneous manufacturing category, where import penetration reached 26 percent in 1984, there are categories, such as signs and advertising displays and office and art supplies, where imports remain minimal.

Figure 5

TRENDS IN U.S. MANUFACTURING OUTPUT, 1979-84

Average Annual Change

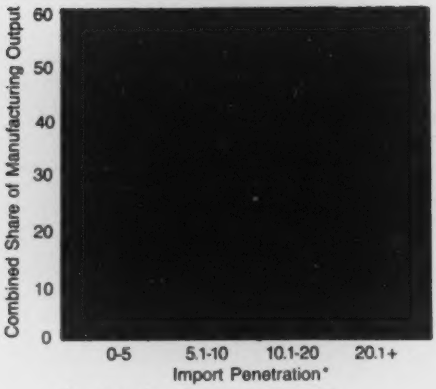


( ) = Average annual change, 1973-79

Figure 6

U.S. IMPORT PENETRATION IN 1984

(In Percent)



*Imports as share of apparent consumption

A few industries will virtually disappear because of changes forced by new technology, shifts in consumer preferences, and rising foreign competition, especially from the lower wage countries. Apart from the sociological concerns, it is important that government monitor the process to ensure that industries necessary to our national security are not lost without full consideration of the consequences. Other industries will develop dramatically—as the microelectronic industry has since the late 1970s. Most industries, however, will alter their product mixes and the way they do business—experiencing changes ranging from production techniques to marketing. Some will not be dynamic enough to make the needed changes, while many others will emerge as tough new competitors.

Many of our basic industries are now facing the most serious adjustment challenges ever. Steel companies, for example, must deal with shrinking industrial country demand for their standard products as well as growing foreign competition, particularly from low wage third world countries. None of the key industries is likely to drop completely out of production in the United States. Some will trim their output and concentrate on profitable market niches, while others will redefine their industries' boundaries—for example, by moving from steel to other parts of the materials industry.

In general, a steadily increasing foreign presence is a fact of life. In real terms, imports moved up from 6.3 percent of U.S. goods consumption in the 1960s to 9.3 percent in 1970 and then leveled off in the 1970s, reaching 11.5 percent in 1980 (see figure 7). As we have seen, it has lately increased rapidly, reaching 15 percent in early 1985. Even if the recent sizable increases slow with a lower dollar, import penetration ratios will likely continue to increase over the longer run as a result of more foreign competition in the U.S. market.

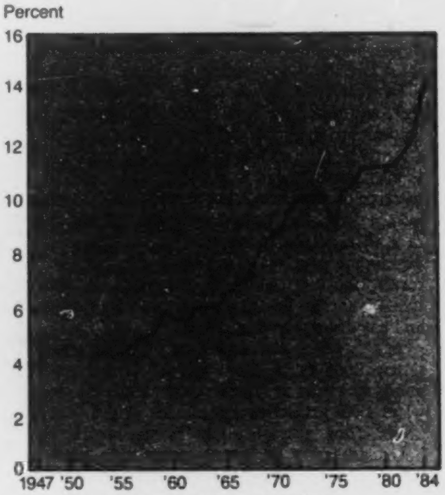
Not all of this, even if it is a predictable trend, is necessarily bad for U.S. industry; more relevant is what happens in the longer term to U.S. exports. Until recently the United States also had been exporting an increasing share of its output, so that exports and imports of manufactures were both increasing at about the same rate. Under such conditions overall U.S. manufacturing was not suffering from foreign dealings. It was, however, having to compete in a more global market context.

Is the United States Giving Up High-Paying Manufacturing Jobs for Lower-Paying "Services" Jobs?

No. The increasing proportion of the work force in service employment is sometimes characterized as involving the loss of high-paying production-line manufacturing jobs, such as those in steel and automobiles, in exchange for lower-paying service-

Figure 7

U.S. IMPORT PENETRATION TRENDS, 1947-84*



*Real import share of domestic goods purchases.

oriented jobs—workers in fast food chains, keyboard operators in information processing, etc. The characterization is incorrect for several reasons.

To begin, there is a wide spectrum of skills required in service industry jobs, just as in manufacturing. Compensation tends to reflect the requirements of the tasks. The highest growth rates are in the more skilled areas, notwithstanding the "fast food" syndrome. Between 1979 and 1984, job gains between 40 and 70 percent were attained in legal, accounting, computer and many other business services, while by comparison employment in eating and drinking establishments increased 19 percent.

Today's service workers include highly skilled computer programmers as well as those who repair complicated telecommunications equipment, word processors, photocopy equipment, and hundreds of other technically sophisticated devices. Indeed, these skilled workers may come to represent the new life blood of American industry. Their work environment will be more challenging than assembly line operations, with their pay matching or topping that of production workers.

Perhaps more significant, much of the "high paying" image of manufacturing jobs stems from wage levels in only a few U.S. industries. Wage levels grew in these industries during the post-World War II period in which the United States enjoyed relative international dominance. Indeed, some manufacturing industries' wages grew well beyond the national average wage, based not solely on productivity, but partly on relatively secure market positions. It should have been obvious that this situation could not persist indefinitely. Indeed, by the late 1960s foreign competition began undercutting wages and profit levels in some basic U.S. industries.

By that time, manufacturing capabilities abroad were approaching U.S. levels. Besides the gains by industrial countries, half a dozen developing countries (the NICs) learned to manufacture sophisticated consumer products and capital goods. Foreign competitors acquired their technology largely from the United States, enabling them to save incalculable time, money, and effort in the development of manufacturing capabilities. As a result, the long standing postwar U.S. competitive advantage has narrowed in some industries—and has disappeared in others.

In the years just ahead, international competition will likely be more intense in manufactured goods than in services, increasing the relative wage level attractiveness of jobs in the "services" areas. Thus, assembly jobs in manufacturing will not necessarily be synonymous with high wage levels.

Will Adjusting Our Industrial Structure to Changing Global Economic Forces Become Easier or Smoother?

Probably not. Indeed, the process of shedding old industries and replacing them with new industries will likely become even more difficult as the pace of technological change quickens. There is no doubt that the U.S. economy, and the economies of all industrial nations, will continue to be confronted with imperatives for structural change at least as powerful as those faced in the past 15 years. Rapid advances in technology, sweeping shifts in consumer demand, major alterations in the composition of basic materials used, and significant reversals in demographic trends will continue to force structural changes, and economies will differ in their ability to accommodate to these changes.

Often people point to the era between 1950 and 1973 and indicate the success the United States and other industrial countries had in coping with change. Unquestionably, during those years the adjustment process was handled with a minimum of domestic distress and international friction. Conditions then, however, were extraordinary. Because the United States emerged from World War II with an extremely strong economy, it accepted the responsibilities to finance the rebuilding of the war-torn industrial states and allowed them to grow rapidly by exporting to an open U.S. economy. The rapid economic growth that resulted provided sufficient new jobs to absorb most of those workers displaced by technological advances and those just entering the labor force. The United States and other industrial country governments, as a result of unusually high growth, could afford to meet the increased demands for new social welfare and environmental programs.

These circumstances could not last, however. With the economic and technological gap closing between the United States and other industrial countries, the competition for global markets stiffened. Meanwhile, the competitive vigor of the U.S. private economy relaxed, large and costly government programs were generated, and crippling inflation was institutionalized. Workers pressed for higher wages to compensate for rising prices and firms found it easy to pass on higher wage costs to the consumer, thus generating an unending inflationary spiral.

Since the early 1970s the United States has had to adjust to increasingly rapid changes in technology, massive jumps in oil prices, and much fiercer foreign competition. Although the adjustment process required by these changes clearly has been painful, the U.S. economy has exhibited great adaptability in coping with change. Our growth in real output during the 1970s exeeded, or at least roughly matched, all other industrial countries except Japan. We shed many of our antiquated industries and, until the dollar soared, halted the erosion in our share of Organization of Economic Development and Cooperation (OECD) exports of manufactures and ran a cumulative current account surplus.

Now, however, we are facing a different set of challenges that will be a new test of our ability to adapt. New technology will play an even greater role in industrial restructuring than in the past ten years. The impact of the microelectronic revolution and the influences of biotechnology and new materials (ceramics, optic fibers, carbon fibers, etc.) are just beginning to be felt. Although new technology constantly has an impact, the shifts now taking place are extraordinary. The pervasive impact of microelectronics must be equated with historical changes as momentous as the development of steam power in manufacturing (mid-19th century) and the introduction of mass production techniques (early 20th century). While these earlier changes took place over several decades, the more rapid diffusion of technology today will greatly shorten the period in which adjustments can take place while maintaining competitiveness.

Besides creating a vast array of new products, the microelectronic revolution is leading to fundamental changes in the production process. Many assembly lines are being reshaped by computer-controlled robotics, a trend that is just getting underway. Perhaps even more importantly, major industrial changes are resulting from flexible machine tools which allow for profitable short production runs of a variety of products. This new technique, combined with the light-weight, high-value nature of many new manufactures, makes it economically feasible to scatter industries geographically.

The economic forces at work are also fostering mergers and alliances among foreign firms within the developed world. Firms in industries whose survivability requires large-scale investments in plant and equipment and research and development (R&D) may be forced into extensive cooperation with similar foreign firms. The aircraft and autombile industries have already moved in this direction, and others are following suit. In attempting to catch up with U.S. and Japanese firms, European companies feel they have little option but to form alliances with foreign firms. Moreover, competition increasingly will take place among multinational firms with a global outlook rather than simply among purely domestic firms with more narrowly based interests.

Because the microelectronic and other new high technology industries which are coming to dominate the industrial landscape are a long way from reaching maturity, the global production structure will remain in a high degree of ferment for many years. An integral part of this unsettling and dynamic process will be shorter product lifecycles—two or three years compared with ten to fifteen years in many metalworking industries. No matter how successful companies may be initially, some will be unable to compete against new products and alliances of competing companies. Moreover, with the rapid spread of technology throughout the developed world, the ability of companies to periodically leapfrog their competitors and capture (or recapture) a market will grow significantly. The result is that industry leadership in numerous product lines will constantly shift, sometimes abruptly, among countries.

In this never ending adjustment process, those who stand to benefit from change are forever at odds with those who stand to lose. Potential gainers seek to alter the rules and structures, while those who would be displaced want to preserve the status quo.

How Can We Best Handle the Adjustment Process?

There is no easy or single answer. The way a society adjusts to secular change is less a matter of deliberate choice than a function of cultural and institutional makeup. There is no right way or wrong way, no single magic formula for success. It may be tempting to single out some particular set of policies or approaches, or some facet of a given country's institutions, and to present these as success indicators or exemplars for other countries to emulate. But when removed from their indigenous social context, these elements often lose their relevance.

This does not mean that government policies and actions cannot stimulate or retard the adjustment process. What it does mean is that their effects are conditioned by the particular social setting in which they operate.

Among the elements often cited as "explaining" a country's industrial dynamism and successful adjustment to change are such things as the way government interacts with the private sector (e.g., the subsidization of distressed industries or the nurturing of emerging ones), the manner in which industry is structured, the emphasis put on welfarism, and the level of the consumer savings rate. But the evidence on the separate or collective impact of these and other elements is by no means clear. What can be said is that industrial societies differ in their institutions, approaches, and policies in these matters. When they try to replicate each other's solutions, they often find that what is good for one country does not necessarily work for another. While the long-term trend toward internationalization of production may well narrow differences among countries, they are likely to remain substantial for some time.

The differences range over a wide spectrum. Some examples:

- *Role of government*. Interaction among big government, big business, and big labor is extensive in Japan and well developed in many West European states. In the United States the relationship among the three groups has been traditionally adversarial, although this is beginning to break down with a growing awareness that a community of interest exists.
- *Industrial organization*. U.S. industrial advances and technological gains depend far more on innovations by small and medium-sized firms than in Japan, where huge, well-established conglomerates more often play that role.
- *Emphasis on welfarism*. Both Europe and Japan are more inclined than the United States toward preserving internal social stability. Europeans approach the problem, for example, by providing income maintenance and by cartelizing or nationalizing through regulations, such as laws that restrain layoffs. Through informal means, the Japanese also assure social stability, and these practices are an important factor in insulating the Japanese domestic market from foreign competition.
- *Methods of investment financing*. U.S. firms are heavily dependent for investment capital on corporate profits and equity financing, while other industrial countries—most notably Japan—rely more on debt financing as a source of investment funds.

These divergent institutional approaches and practices do not add up to an explanation of why industrial countries differ in the degree and quality of their economic dynamism and adaptability. It seems that the most effective and least painful adjustment process is one that relies on fundamental strengths. For the United States, these strengths include a very high degree of flexibility that rests on a broad-based economy, a great diversity of political constituencies, and relatively unimpeded mobility of labor, capital, and know-how. These unique national assets should be relied upon to facilitate structural adjustment.

Governments that have acted to slow the industrial adjustment process through impeding access to their markets have had limited success, especially in the long run. For example, the steel industries of the United States and Western Europe have shrunk in part because of reduced demand, the rise of smaller, more efficient mills, and use of substitute materials. Foreign competition in our markets, including unfair practices by some trading nations, while certainly an important factor in the decline in big steel, has not been its fundamental cause.

Invariably, attempts to save sick industries have been costly for other industrial users, and for consumers and taxpayers. In general, while marginal short-term relief has been achieved by restraining the growth of foreign imports, the burdens of the resulting costs and inefficiencies are frequently placed on the remainder of the country's more efficient and competitive industries.

Import relief, however, is needed against unfair competition and may be beneficial if applied only temporarily. For example, limited import restraints coupled with dedicated investment in new technologies and processes have worked in the specialty steel industry, which comprises roughly 10 percent of total steel output. In the absence of unfair foreign competition, manifested by sales below fair value and with the aid of government subsidies, this vital segment of our industrial base would not have required import relief.

CRUCIAL BILATERAL AND MULTILATERAL TRADE ISSUES AHEAD

I have already commented on the serious dangers for our industrial base and economic vitality that may arise if the dollar remains near present levels. But even if the dollar does decline sufficiently, there are bilateral and multilateral aspects of our international competitive position which I believe must be addressed.

Japan's Competitive Strength and Market Access Barriers

Japan, with its growing technological strength, has become the most formidable competitor for the United States. Japan has moved into many U.S. traditional industries—autos, steel—and is challenging in high technology sectors where we are world leaders, such as semiconductors, computers, telecommunications, and biotechnology. Indeed, the Japanese dominate some segments of key high technology markets. Japan is now our major competition in sectors that will drive future economic growth throughout the industrialized world. In some key industrial products, the Japanese have attained a large share of the U.S. market (see table).

The source of our concern about Japan is not simply Japan's competitive strength, but more fundamentally that Japan's strength is bolstered by practices and policies that deny to American

Table
Japanese Share of U.S. Market for Select Commodities, 1984
(percent of apparent U.S. consumption in value terms)

Commodity	Percent Share
VCRs	99
Motorcycles	95
256K DRAM semiconductor devices	47 *
Numerically-controlled machine tools	37
Metal-cutting machine tools	21
Automobiles**	18
Telephone and telegraphic equipment	7

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* Japanese supply 90 percent of U.S. commerical market.
**Units.

firms reciprocal access. The problem is lack of equity. While the U.S. market remains wide open to Japanese companies, the Japanese market is difficult and costly to penetrate by U.S. and other foreign firms. Indeed, Japan clearly is the exception in market openness among industrial countries. Japanese imports of manufactures as a share of manufacturing output increased only slightly from 1960 to 1984—from 7 percent to 9 percent. In the United States the same share rose from 5 percent to 29 percent. All other major developed countries followed the United States' path (see figure 12).

Some specifics, for example:

- The Japanese space agency still refuses to allow Japanese government agencies (including NTT) to purchase foreign-made satellites. NASA continues to meet its international obligations under the Government Procurement Code in making its purchases.
- The Bank of Tokyo, Japan's central bank, buys currency recognition equipment only from Toshiba. The U.S. Federal Reserve is funding product development in this area by the principal U.S. supplier—but also by Toshiba (and other foreign companies).
- Single tendering is still used by the majority of Japanese ministries to avoid giving foreign suppliers a chance to bid on government contracts.
- Ministry of Health and Welfare standards and procedures are still used to keep competitive U.S. drugs and medical equipment out of the Japanese market until local producers have established a position. Japanese firms have been free to acquire interests in our most innovative biotech firms and institutions. The FDA has moved to even more liberal treatment of Japanese imports.
- NTT procurement of U.S. telecommunications equipment is still only $130 million, or less than 4 percent of NTT's procurement budget. At the same time, the United States has a $2.3 billion trade deficit in telecommunications equipment with Japan.

Numerous entrenched barriers to trade have kept manufacturing imports to a minimum and have provided Japanese firms with a large domestic market to develop infant industries and to protect those in decline. In this sheltered environment, their conglomerates concentrate on what they perceive are the fastest growing product lines. They then pump enormous capital into plant and equipment in these selected product lines, and the resulting rapid increases in productivity gained through modern equipment and efficient production techniques push costs down quickly. They next move beyond their protected home markets, lowering prices and quickly securing a large share of foreign markets. In one degree or another, these strategies have been followed in steel, cameras, automobiles, consumer electronics, random access memories, and telecommunications equipment.

The U.S. Government has been trying to persuade the Japanese to lower their import barriers for more than 20 years with only modest success. Indeed, our trade deficit with Japan climbed from $12 billion in 1980 to $37 billion in 1984 and probably will reach $50 billion in 1985. Some indicate our problem is due mainly to the strong dollar or to the lack of effort by U.S. business. But these arguments are not sufficient. We have had trade problems with Japan when the dollar was strong and when it was weak. Moreover, the problem is not limited to the United States. Other countries, such as West Germany, Switzerland, South Korea, China, Hong Kong, and Singapore all have the same problems in Japan that we do.

The main problem is that we are not dealing mainly with explicit barriers, such as tariffs and quantitative restrictions, but with deeply rooted ways of doing business, including an ambiguous bureaucratic process, informal cartel arrangements among major producers, and an unwritten understanding under which Japanese buyers purchase goods mainly from Japanese firms.

The hurdles for the foreigner are further complicated by the Japanese emphasis on avoiding adversarial confrontation through on-going personal ties and well-observed attention to hierarchies. This "keiretsu" system dominates Japanese industrial organizations. U.S. firms have difficulty in accessing industrial advisory groups, associations, standards groups, and structural councils, all of which are central to Japanese industrial and trade policy processes. These barriers evolved from a social-economic system which for decades has focused on encouraging exports, controlling imports, and limiting foreign involvement in Japan's domestic economy.

The Japanese will not modify their system unless they realize they will lose more by maintaining it. In the last four years the Administration has had notable success in gaining commitment from the Japanese Government for new liberalization measures.

Where important interests are involved—such as telecommunications and software issues—we have shown that the United States can influence Japanese Government policy. However, "commitments" have not yet been translated into an improved trade balance. As the list of commitments has grown so has the perception of our market access problem.

We must react quickly and forcefully to those instances where Japanese bureaucrats are tempted by past patterns of protectionism. We must continue to insist that representatives of U.S. firms be permitted to participate in all of the informal decision-making processes of Japanese industrial groups that affect imports. We must insist that our businessmen obtain the same opportunities in the Japanese market that their firms enjoy in our country.

Prime Minister Nakasone has made strong public statements exhorting the Japanese to buy more foreign goods. The Japanese Government needs to put into place the means to make this happen. Unless progress in opening the Japanese market to foreign competition becomes a reality in the near term, Congress likely will seize the initiative on trade policy with unpredictable results. After all, the U.S. Government's credibility—and the credibility of the GATT-based global trading system—is called into question by the fundamental lack of equity between Japanese trade practices and those of other industrial countries. We have taken courageous actions to resist protectionism but equally stouthearted measures are needed from the Japanese if the liberal trading system is to continue.

Effects of the NICs and Latin American Debt on U.S. Trade Prospects

The rising trading power of the six newly industrializing countries (NICs) and the huge debt of Latin American countries are relatively new factors that significantly affect U.S. trade prospects. Unfortunately for the U.S. trade balance, both will endure for the foreseeable future.

Four East Asian NICs—Hong Kong, South Korea, Singapore, and Taiwan—have been a growing ~~factor in U.S.~~ trade for more than a decade. Indeed, these countries are becoming an integral part of the U.S. economy. Although their combined GNP is less than one-tenth that of the European Community (EC), U.S. imports from these countries are about two-thirds of what we import from the EC. Two Latin American NICs—Mexico and Brazil—have also been rapidly increasing their exports of manufactures to the United States. Between 1981 and 1984, U.S. imports of manufactures from the six NICs climbed more than two-thirds, while total manufactures imports from all countries rose 54 percent. Imports (c.i.f.) of manufactures from all six NICs totaled $50 billion in 1984, or about one-fifth of total U.S. manufactures imports (see figure 8).

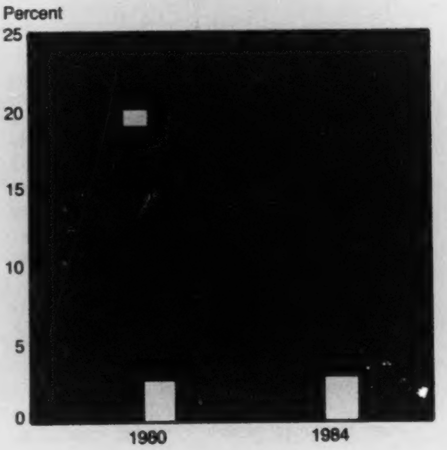
This increasing penetration of U.S. markets by the NICs evidences their rapidly growing manufacturing capabilities. These capabilities include production of relatively sophisticated products. Indeed, the United States has had high technology trade deficits with the Asian NICs for each of the last five years.

The competitive pressures from the NICs are not likely to slacken. To the contrary, they are likely to become stronger as the manufacturing and trading skills of the NICs continue to increase. The East Asian NICs, particularly, will continue to grow in importance as competitors in the world manufactures market. They have low wage rates, rising educational levels, strong work ethics, and increasingly well-developed infrastructures to sup-

Figure 8

NEWLY INDUSTRIALIZING COUNTRIES: SHARE OF U.S. MANUFACTURES IMPORTS

1980 and 1984



port an expansion of manufacturing. The ability to diversify into new products has been a prime factor in their past success and will continue to be important as they will be increasingly challenged in traditional labor-intensive product exports by other developing countries. As a result, the East Asian NICs almost certainly will become more competitive with the industrial countries in additional capital- and technology-intensive products. Brazil and Mexico will expand their manufactures and high tech exports somewhat less rapidly, but they also will be increasingly competitive.

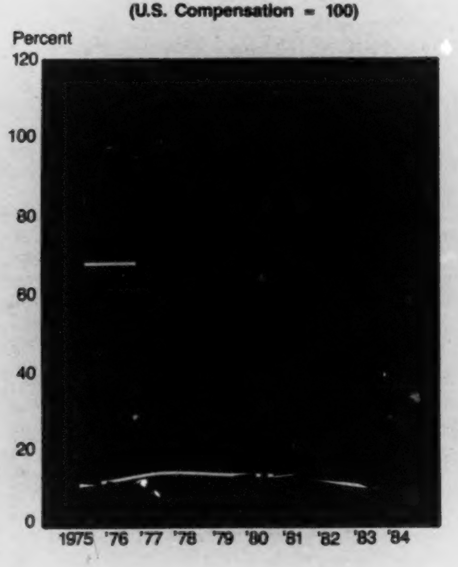
A decline in the dollar may not significantly reduce the competitive power of these NICs, since most of their currencies are managed so as to maintain a targeted relationship with the dollar. As a result, their wage costs have remained about 10 to 20 percent of ours (see figure 9).

These much lower costs not only reduce the wages that go into every product, but they hold down indirect manufacturing costs. Most often, the funds spent on building a new plant are less in the NICs than in the United States, as are the costs of the multitude of services that support production operations. About one-third of total U.S. exports go to LDCs, many of which have significant external debt problems. The severe cuts in their imports required to save foreign exchange for servicing their debts have been a sharp blow to U.S. export performance since 1981.

Figure 9

NEWLY INDUSTRIALIZING COUNTRIES: HOURLY COMPENSATION COSTS FOR PRODUCTION WORKERS IN U.S. DOLLARS, 1975-84

(U.S. Compensation = 100)



U.S. exports to these debtor countries dropped by $18 billion between 1981 and 1983. Virtually all of this loss was with six Latin American countries—Mexico, Brazil, Argentina, Venezuela, Chile, and Peru. In 1984, U.S. exports to some of these debtor countries recovered somewhat but were still well below peak 1981 levels. At the same time, the United States in 1984 absorbed large import increases as debtor countries struggled to increase their foreign exchange earnings.

While some of the debt-troubled Latin American countries appear to be gaining control of their problems, and although further import cutbacks by most of these countries seem unlikely, a significant improvement in the U.S. balance of trade with them also seems unlikely. Most Latin American debtors must continue to generate trade surpluses to enable them to service their debt. This implies continued constraints on their ability to import from the United States and continued pressure to export.

In sum, competitive pressures from NICs and Latin debtor countries will continue for the foreseeable future, even in the face of a substantial decline in the dollar.

SUMMARY AND POLICY IMPLICATIONS

Clearly, a significant number of U.S. firms and industries now are in very difficult straits, with many of their immediate problems caused by foreign competition. Across the broad spectrum of American industry, however, there is remarkable vigor and dynamism. Investment is strong; new products and processes are being developed; in many industries there is a surge of pride in manufacturing; and in some high technology industries there are even indications that some offshore production may return to the United States.

But there are immediate problems and longer range trends of utmost concern that, if not adequately treated, may have very undesirable long-term consequences for the U.S. economy.

U.S. Manufacturing—Stay or Go?

The recent U.S. manufactures trade deficits are a symptom of the growing lack of competitiveness of a number of U.S. manufacturing industries in international markets. A U.S. dollar that has been too strong for too long is by no means the only factor contributing to reduced U.S. competitiveness, but it is certainly the single most important factor.

An increasing number of U.S. firms are on the verge of decisions to move to foreign production or foreign sourcing in lieu of U.S. manufacturing. Some of the same U.S. companies and others also are giving up export markets and dismantling their overseas marketing and servicing operations. While some of these movements are a normal part of the dynamics of a global economy, the overly strong dollar is motivating otherwise unwarranted movements of manufacturing from the United States—movements that would not occur with a dollar that better reflected price competitiveness among developed countries. These movements, if they occur, will have significant long-term negative consequences for U.S. industrial strength and trading capabilities.

The perceptions of U.S. firms about the duration of a strong dollar have an important role in "stay or go" decisions. Once made, "go" decisions are not quickly or easily reversible. Unfortunately, most forecasters now appear to expect only modest declines in the dollar in the near term. I have no magic prescriptions for reducing the value of the dollar, but certainly the necessary actions would include reducing our federal budget deficit and urging our trading partners in the major industrial nations to bolster their domestic economic activity. Such actions could begin the process of altering perceptions by showing that the problems are recognized and something is being done about them.

Bilateral Problems Ahead

While I see the most important development over the next year or so as the path of the dollar, we also face a number of more entrenched problems. These include the bilateral aspects of our trade relations with several countries. Less recognized than our disputes with developed countries is the rising trading power of a number of NICs and the effects on U.S. trade of conditions in several less developed countries—particularly, the Latin American debtor nations.

The bilateral trade problems that will be engendered by these factors can only be expected to increase. This does not diminish the imperative for emphasizing our commitments to the multilateral trade system. But as the world's largest trading nation, providing the largest single market for the exports of many of our trading partners, we should anticipate an increasing need for bilateral trade negotiations.

In regard to the more advanced of the NICs, we must begin to consider them as industrial nations, with all the *rights* and *obligations* involved. If we do not soon work out new trade relations with them, we will find protectionist practices becoming entrenched, requiring the same long and arduous negotiations that we have had with the Japanese. I believe the NICs should, selectively, be brought into the industrial country framework in a step-by-step manner in which their trading practices would be aligned with those of traditional industrialized countries.

We must also understand that in pursuing "free trade" we need to distinguish between the world as we might like it to be and as it actually is. It would not advance our own secular interests or those of our trading partners if we turned a blind eye toward practices that are inherently unfair as measured by U.S. laws and international understandings. From time to time, a few have argued that "foreign dumping is good for us" since the consumer apparently benefits from lower prices. The fact is that support for the pursuit of the ideal of free trade can be maintained only as long as we enforce our laws and insist that there be rough equivalence in how the rules of international commerce are observed.

Surviving and Prospering in a Tougher, More Competitive World

Even with a dollar decline and improved foreign economic growth, as well as progress in resolving bilateral trade problems, we will face an increasingly competitive international economic environment over the years ahead. Technological change is accelerating, communication systems are becoming faster and cheaper, and transportation is moving products more quickly. Most importantly, human capital abroad is constantly improving. For example, one indicator of change is reflected in education levels. In 1960 the United States produced about 20 percent of the world's high school graduates; in 1980 we produced only 9 percent, and by 1990 it is estimated that we will produce only about 7 percent of the world total of high school graduates. This does not reflect a reduced emphasis on education here, but simply continued progress in other parts of the world.

Our industry clearly will be challenged by unrelenting and dynamic changes and by growing foreign competition. It is a fact of life that cannot be dismissed. Our ability to accept and effectively deal with this unceasing adjustment process will determine our long-term competitiveness and, more importantly, the well being of the U.S. economy and the ultimate security of the United States. There are no simple answers or prescriptions that can be put forward to ensure our commitment and effectiveness in meeting this challenge. In my opinion the only way we can do so is by relying heavily on our strength—the vigor and versatility of U.S. entrepreneurs and workers. What is involved is continuous and intense dedication. I can assure you the effort will not be easy and the debate will be hot and constant. There will be many winners but also losers, and because of the pain felt it is the latter that will attract most attention.

The U.S. Government's role in meeting this challenge is to create a positive atmosphere, and to press for the removal of both domestic obstacles to achieving a more competitive industry as well as foreign barriers to U.S. goods and services. The Administration is moving forcefully ahead in these areas and we must ensure that the progress continues. The effort to deregulate must be pressed forward to obtain more efficient use of capital and labor, and the President's tax proposals, if adopted, will encourage adjustment and the savings needed for new investment.

We must take a strong stance with our major trading partners who are pursuing regulations and practices that hinder the sale of U.S. goods in their markets. It is the only way to ensure that we and other countries continue to enjoy the immense benefits of the international trading system that have emerged in the past 40 years. If other countries do not provide us the same market access we provide them, sooner or later, the U.S. populace through Congress will take action to close off the U.S. market to foreign offenders.

As long as we are making progress in reduction of foreign barriers we must resist the temptation to employ protectionist devices that would seem to insulate us from the forces of global competition. It is clear to me that we cannot long compete by attempting to hobble our competition. Rather, the only way to win this race is to run faster and be smarter than our competitors. Protectionist measures often have short-term appeal, but in the longer term they are equivalent to attempting to lift one's self by one's own bootstraps.

PART II
A REVIEW OF GLOBAL TRENDS IN MANUFACTURING AND TRADE

In this part of my report, I describe the changes that have occurred in the U.S. international competitive position since the early 1970s and the factors influencing these trends. The emphasis is on U.S. trade in manufactures, which has accounted for most of the nonenergy shifts in the U.S. international balance in goods and services. In addition, an attempt is made to gauge what may happen in the next few years, looking at plausible alternative trends in the dollar and the U.S. and global economies, and the impact of these trends upon the U.S. industrial base.

BACKGROUND

In 1971, for the first time in more than 80 years the United States ran a merchandise trade deficit. This event more than any other symbolized the start of a debate—which continues to this date—as to the forces which shape the ability of the United States to compete in the world marketplace. Until the early 1970s our domination of international markets had been taken for granted and relatively little attention was paid to international economic issues. For more than two decades, however, our competitors have been closing the gap. Although slippage in our postwar dominance was inevitable—and desirable if we were to ensure strong trading partners—concerns increased that the United States was losing its economic vitality.

Now, with the U.S. trade deficit at levels that were unimaginable just a few years ago, the decline in competitive strength of U.S. industry has taken on an even greater urgency. In assessing the current problem, we first examine general global industrial trends in the years since World War II and then take a more detailed look at the 1970s and 1980s.

GLOBAL INDUSTRIAL TRENDS

Manufacturing output in the developed countries grew at the extraordinary rate of nearly 6 percent per annum between 1950 and 1973. The group's industrial capacity as a result increased four-fold, making those 23 years the most expansive by far in global history. Since 1973, the growth pace has fallen off by more than half, dropping to what might be considered a more normal clip by historic standards. At the same time, the newly industrializing countries (NICs) emerged as major providers of manufactures to the developed world. By the mid-1980s the NICs were supplying nearly 20 percent of all developed country imports of manufactures, compared with less than 5 percent in the early 1970s.

During the 1950s, manufacturing output in continental European countries and in Japan grew at a much faster rate than in the United States as a result of postwar restoration (see figure 10). By the 1960s U.S. production about matched the rise in many European countries, while Japan, beginning from a low base, continued to grow rapidly as it closed the sizable industrial gap between itself and other members of the developed world. While production slowed considerably throughout the developed world after 1973, the United States usually matched or outpaced European countries. Between 1973 and 1984, however, Japan doubled its manufacturing output, while the U.S. level climbed about one-quarter. In fact, while the United States and Western Europe faced a further reduction in growth rates in manufacturing output after 1979, the Japanese post-1979 manufacturing output expansion rose faster than during 1973-79. Much of the improved Japanese industrial performance reflected a boost in the volume of manufactures exports from 8.5 percent per year in the earlier years to 9.6 percent from 1979 to 1984.

The NICs did spectacularly well during the 1970s (see figure 11). Their manufacturing output even rose faster than Japan's. South Korean output climbed an astonishing 23 percent annually between 1973 and 1979. NIC expansion rates slowed considerably after 1979 and in Brazil output in 1984 was below the 1979 level. The Far Eastern NICs, however, roughly matched the sizable Japanese manufacturing output rise in the 1980s. Although Mexico and Brazil fared poorly, their exports of manufactures continued to rise sharply, based mainly on sales to the United States.

STRUCTURAL CHANGES AND INFLUENCING FORCES

Beneath these general industrial trends there have been dramatic changes in the global industrial structure. Most important has been the emergence of major new players—the Japanese, especially from 1960 through the early 1970s—and more recently the NICs. The arrival of new entrants in international markets has exerted intense pressure on less sophisticated industries; many went into decline or were eliminated. By the late 1970s, Japan was challenging the United States in many high technology goods that we once dominated. Other changing conditions that have had a major impact on industrial restructuring include:

- The transformation of modern society through enhanced information processing.
- Explosive growth of the microelectronics industries.
- The trend in energy costs; continuously lower costs from 1950 to the early 1970s, followed by the sudden surges in prices in 1973 and 1979, with some declines since.

Figure 10

INDUSTRIAL COUNTRIES: TRENDS IN MANUFACTURING OUTPUT, 1950-84

(Average Annual Percent Change)

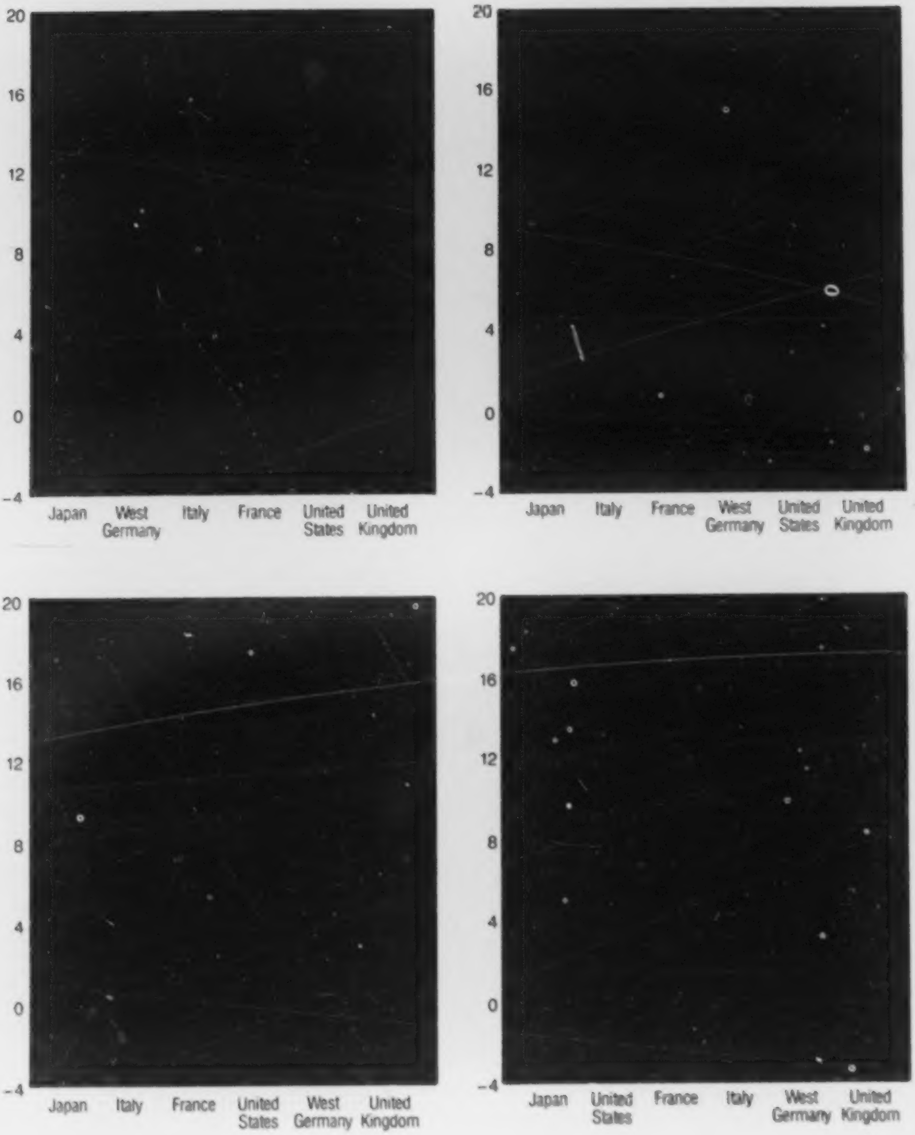
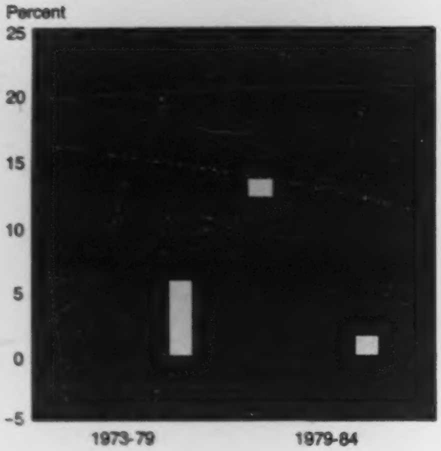


Figure 11

NEWLY INDUSTRIALIZING COUNTRIES: TRENDS IN MANUFACTURING OUTPUT, 1973-84

Average Annual Change



- The substantial slowing of industrial-country economic growth after 1973.
- The reintroduction of floating exchange rates in the early 1970s and the phenomenal expansion of international capital markets.

These and similar changes always have been responsible for industrial restructuring within industrial countries. What is different now is that the pace of change has quickened and the shifts have become less domestically oriented. For example, during the late 1940s and 1950s much of the U.S. textile industry was restructured as it moved from New England to the South. Since then, however, industries have migrated offshore and there is an increased dependence on foreign markets and suppliers (see figure 12). Between 1960 and 1980, and especially during the 1970s, both exports and imports of manufactures of almost every major developed country have risen dramatically compared with their manufacturing output. The notable exception is Japanese imports of manufactures, which have remained at nearly the same low level as a percent of output since 1960.

While the general trend clearly indicates increased dependence on finished foreign goods, it also reflects a much expanded movement of intermediate goods across national boundaries. In fact, more major firms are making their decisions to buy parts and components for their U.S. assembly operations on a global rather than a domestic basis. Countries generally are becoming less self-reliant in their ability to manufacture the full range of goods needed in any single production process.

The increasing integration of international markets has been a self-reinforcing trend as firms try to remain competitive.

- Many firms are tending toward specializing in items in which they can achieve an international market niche, rather than produce a full range of products for domestic markets.
- Firms from various countries are pooling their financial resources, technology, and marketing expertise because the cost of launching many new products has become too expensive for individual firms and because national markets are no longer large enough to ensure an adequate return on investments.
- Many industrial firms are internationalizing their production processes to lower costs and to ensure better market access. In the aircraft, electronic products, and automobile industries, companies are producing parts and components in several countries and often assembling them in others. In the case of many new small-sized, high-value items such as semiconductors, the product typically crosses international borders many times as it moves through the stages of production.
- Firms producing sophisticated products are moving some of their operations closer to their customers so they can better compete in the increasingly important markets for tailor-made items.

While these dynamic market forces have been mainly responsible for global industrial trends, governments have attempted to accelerate or retard these developments. Most notably, Japan has been effective in funneling funds and resources toward targeted growth industries and in protecting declining ones from foreign competition. European states have funded and subsidized a commercial aircraft industry in order to compete with U.S. companies. Large scale U.S. spending on defense and space has helped many U.S. industries maintain or gain a competitive edge. Most NIC governments have poured vast sums into new industries and have strongly protected them in their infancy.

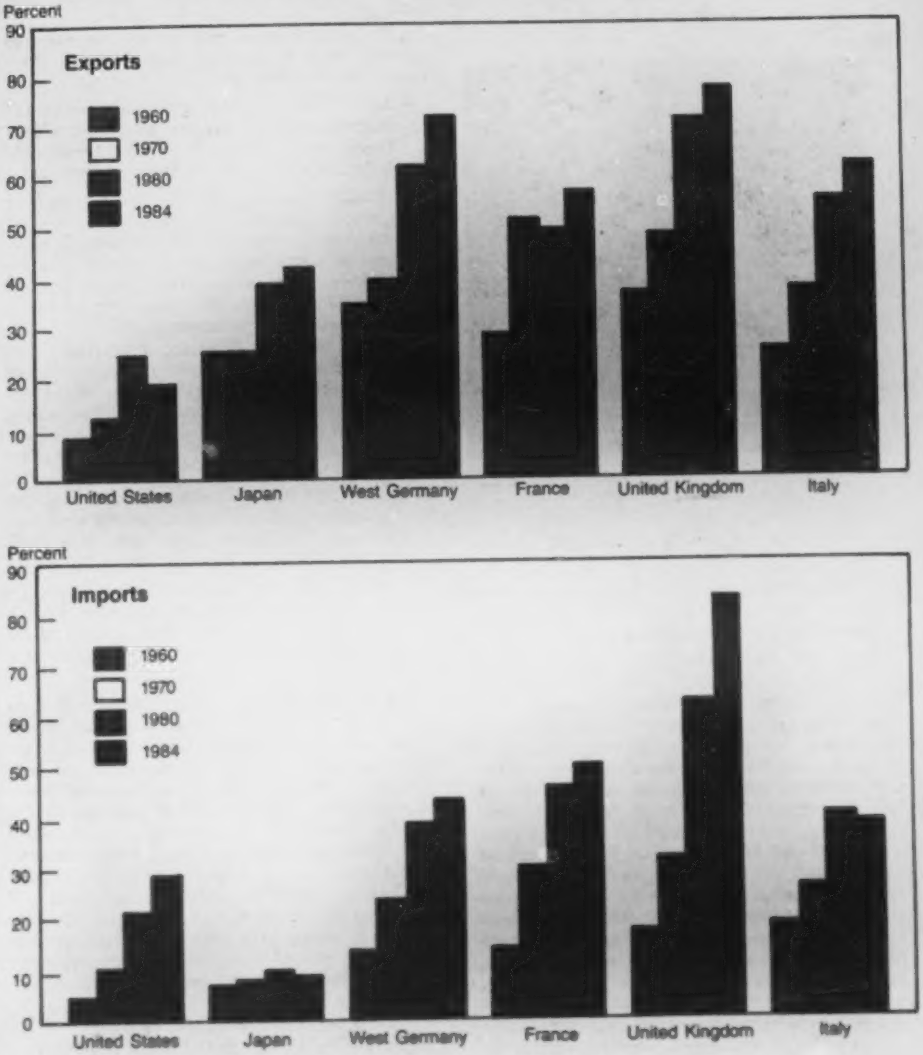
CHANGES IN THE TRADE ENVIRONMENT AND THEIR IMPACT DURING THE 1970s.

The Setting

In looking at the troubled decade of the 1970s we would be badly misled if we failed to take into

Figure 12

INDUSTRIAL COUNTRIES: MANUFACTURES TRADE AS A SHARE OF MANUFACTURING OUTPUT, 1960-84*



*Exports, f.o.b.; imports, c.i.f.; manufacturing output — value added.

account the exceptional nature of the halcyon decades of the 1950s and 1960s. These were decades of extraordinary postwar growth during which the badly mauled economies of Western Europe and Japan were restored to major status in the world economy, closing the economic gap with the United States. The high-growth momentum of those decades could not have been sustained much longer in any event. A slowing was already apparent in the United States after 1966. But the two OPEC shockwaves of the 1970s put an extra heavy damper on the performance of all the big capitalist economies. Real growth fell and inflation and unemployment rose in all of them.

A rise in economic frictions was also inevitable. From World War II to the early 1970s, governments in the industrial countries found they could pursue policies at home which were both in their national interest and in the common interest. All parties supported the reconstitution of the war-torn West European and Japanese economies as a means to stiffen the western world's opposition to Soviet expansionism, to bolster global economic growth, and to guard against the disastrous conditions which existed during the 1930s. The United States helped by promoting the removal of industrial country trade barriers, providing a stable international financial system, and absorbing rapidly growing exports from other developed countries. These policies benefited the U.S. standard of living. They could be pursued without creating undue internal political strains because the United States had a strong and highly competitive economy. But by the late 1960s, many U.S. industries were beginning to feel the pinch of foreign competition, then as now reflecting an overvalued dollar.

As a result, the industrial world returned in the 1970s to the normal state of affairs whereby it is necessary to more closely mesh conflicting national policies. Moreover, the very need to change attitudes that carried over from the earlier decades made matters worse. Countries that had become accustomed to policies and practices that had served them successfully for so long were naturally reluctant to abandon them. Some developed countries, especially Japan, resisted opening their markets to foreign goods.

Changing Current Account and Trade Positions

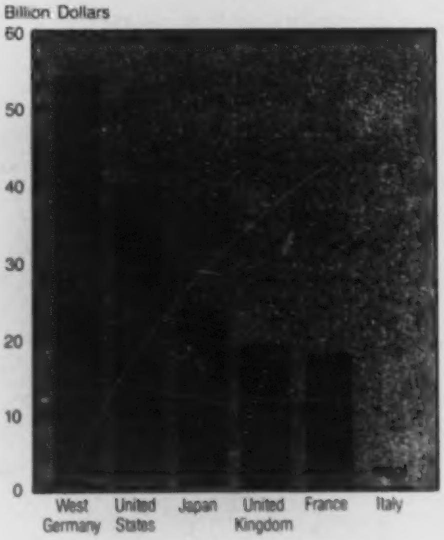
The most comprehensive and telling measure of an industrial country's economic strength in international markets is its balance on current transactions—merchandise, services, return on capital invested abroad, and salaries earned abroad. From the early 1950s through the middle 1960s, the United States ran fairly large surpluses while the other industrial countries had deficits. But by the late 1960s, the U.S. current account position began to deteriorate sharply, reflecting continuing market share losses to other industrial countries. In the early 1970s, it became clear that the dollar was overvalued.

The realignment of the key world currencies against the dollar and the introduction of floating exchange rates in the early 1970s clearly helped improve the U.S. current account and competitive position. During the 1970s, the United States earned far more than it paid out for goods and services, despite a trade account that was usually in deficit. Its cumulative current account for those years was in surplus by some $40 billion, an amount that topped all other industrial nations except West Germany (see figure 13). This current account surplus was achieved through positive balances in manufactures and agricultural trade and services, which more than offset the rising oil import deficit.

The U.S. share of world merchandise exports, measured in current dollars, declined modestly in the 1950s and 1960s and fell sharply in the 1970s. But exchange rate and price movements (dramatic changes in the value of the dollar, the huge jump in oil prices) convey a blurred image. In physical

Figure 13

INDUSTRIAL COUNTRIES: CUMULATIVE CURRENT ACCOUNT POSITION, 1971-80*



*Goods, services and private remittances.

volume, the U.S. share of world exports actually increased slightly in the 1970s.

Looking at manufactures alone, exports and imports grew at about the same rate. Although foreign goods gradually increased their share of U.S. demand, U.S. manufacturers also were increasing the share of goods they exported. The net impact of foreign trade on total manufacturing employment appeared minimal.

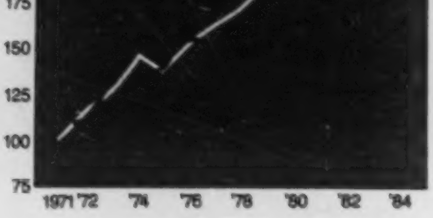
For the decade of the 1970s as a whole the volume of U.S. exports climbed almost as rapidly as that of Japan and faster than that of most of our European competitors (see figure 14). The U.S. share of OECD exports of manufactures thus was actually higher in 1980 than at the beginning of the 1970s. The United States did particularly well in the rapidly growing markets of the NICs. Although sales to OPEC members also increased substantially, the U.S. market share fell slightly, while Japan and Italy made gains.

The changeover in the early 1970s from a fixed to a flexible exchange rate regime has had an enormous impact on the trends in U.S. foreign trade and those of other industrial countries. While the new system was largely responsible for arresting the long-term erosion in the overall competitive position of the United States in world markets through the 1970s, it also was a major factor behind the erratic behavior of the U.S. balance of manufactures trade and U.S. market shares of industrial country exports of manufactures. The decline in the value of the U.S. dollar against other major industrial country currencies in the early 1970s and again in the late 1970s was largely responsible for the improved U.S. balance of manufactures trade that took place a year or so later. In contrast, the improvement in the dollar's value from 1973 to 1976 was partly responsible for the deteriorating trade balance from 1975 to 1978.

Figure 14

INDUSTRIAL COUNTRIES: MANUFACTURES EXPORT VOLUME, 1971-84

(Index: 1971 = 100)



Changes in the value of the dollar, besides altering the competitiveness of U.S. goods in world markets, also had important domestic implications. The sharp devaluation of the dollar in the early 1970s, for example, clearly had an inflationary impact on the United States. Besides the direct effect of the higher prices paid for foreign goods, many U.S. manufacturers found they could easily increase domestic prices and still be competitive against imports.

Employment and Productivity

While the differences among industrial countries in economic growth rates narrowed during the 1970s, the manner by which each attained its economic gains varied considerably. Much depended on each country's particular circumstances and its political-economic institutions.

The United States achieved its economic growth by putting people to work rather than increasing their productivity. Unlike Western Europe and Japan, where employment grew very little, the United States had to cope with a massive influx of new entrants into the labor force as the children of the 1950s "baby boom" entered the labor market. It also moved from a position of having one of the lowest proportions of females employed in the late 1960s to having the highest proportion by the late 1970s. Finally, the United States absorbed the largest rise in immigrant workers during the 1970s.

Almost 19 million new jobs were created during the 1970s—a net increase in the employed labor force of 23 percent. U.S. firms, therefore, not facing a tight labor situation and not benefiting from the greater capital availability in other industrial countries, often found it more profitable to hire additional workers than to invest in labor-saving equipment. Nearly all the new jobs were in services, but employment in manufacturing establishments rose 9 percent.

In Western Europe the emphasis clearly was on increased productivity, which climbed in most countries at a rate nearly three times as fast as in the United States. Europe faced a much slower rise in the size of the working-age population and had a much smaller increase in female participation in the labor force than the United States. In addition, the number of "guest" workers declined after

1973. Even so, with few new jobs being created, unemployment climbed sharply; manufacturing employment actually fell in Europe. By 1980 most European countries had jobless rates that matched those of the United States, while in the early 1970s European unemployment had hovered at a low level. West European firms focused heavily on labor-saving capital investments because of considerable union and public agitation for much higher wages and greater social-welfare benefits.

In Japan, rapid technological improvements (much of which was achieved because of the U.S. Government's permissiveness as to the transfer of domestic firms' technology from private companies and the incentives given by the Japanese Government to domestic firms to make use of new technology), coupled with forward-looking management, brought a rapid rise in productivity. The demographic pressure for creation of new jobs in Japan was much less than in the United States, and the Japanese female participation rate even dropped in the 1970s. In addition, the Japanese labor force contains few foreign workers. For much of the decade, the Japanese feared labor stringencies, a factor that gave emphasis to increased investments in labor-saving equipment.

MAJOR SHIFTS IN THE TRADE ENVIRONMENT SINCE 1980 AND THEIR IMPACT

The Setting

Global economic trends changed dramatically in recent years and have turned out much differently than most observers had predicted in the late 1970s.

- Oil prices fell, rather than climbing to the often forecast level of 50 to 100 dollars per barrel.
- Inflation throughout the industrial world dropped substantially, rather than continuing along the often predicted course of near 10 percent a year.
- U.S. economic vitality once again became highly regarded abroad, while in the late 1970s it was viewed to be continuously deteriorating.
- Euro-pessimism replaced Euro-optimism. In the late 1970s, many Europeans thought that with the United States faltering, they would have to lead the global economy. Now European leaders are enmeshed in the problems of reigniting their own economies.

During the early 1980s, the United States once again became the locomotive of global economic growth. Our domestic consumption outpaced increases elsewhere. Both real GNP and domestic demand of most European countries rose much less rapidly than that of the United States in the 1980s (see figure 15). Although Japanese GNP climbed faster than in the United States, Japan's domestic consumption increased at a slower pace. In essence, a large share of industrial country and NIC growth has been attributable to exports to the United States. In Japan, for example, foreign trade accounted for about half of the GNP growth in three of the last four years.

Major changes also have occurred in trends in U.S. industrial output and in our current account position, especially manufactures trade:

- Since 1979, some 40 percent of the increase in manufacturing output has been attributable to defense and space production, compared with only 5 percent in the 1973-79 period.
- Productivity gains in manufacturing have sped up significantly as substantial new investments are being poured into improving the efficiency of the U.S. industrial base.
- The cumulative U.S. current account deficit during the 1980s reached $115 billion by 1984, while other industrial countries ran surpluses or small deficits (see figure 16). This reverses

Figure 15

INDUSTRIAL COUNTRIES: TRENDS IN REAL GNP

Average Annual Change

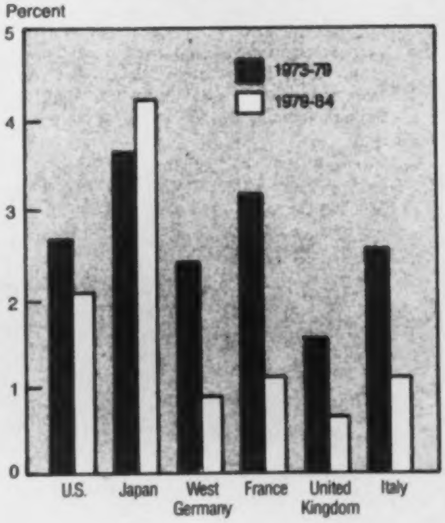
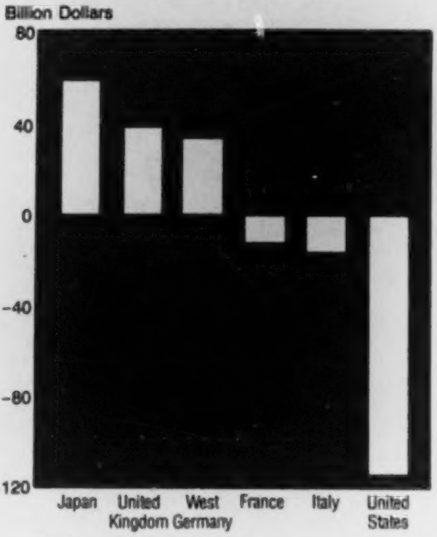


Figure 16

INDUSTRIAL COUNTRIES: CUMULATIVE CURRENT ACCOUNT POSITION, 1981-1984*



*Goods, services & private remittances.

the 1970s trend, when the United States had a cumulative surplus that topped all other industrial countries except West Germany.

- Most of the deterioration in the U.S. current account position resulted from a sizable shift in our manufactures trade balance. It changed from a surplus in 1981 to an unprecedented $81 billion deficit in 1984 (see figure 17).
- The 1983 manufactures deficit was nearly triple and the 1984 deficit more than six times the previous high set in 1978. The deficit reached the equivalent of 10 percent of manufacturing output in 1984, while the same share in 1978 was 2.4 percent.
- Exports and imports of manufactures no longer increased at about the same rate, as they did during the 1970s. Between 1979 and 1984 the volume of exports of manufactures rose 23 percent and imports soared 95 percent (see figure 18).
- The only favorable trade shift was in petroleum. The U.S. deficit declined from $74 billion in 1981 to $63 billion in 1984. The agricultural balance lost some ground but remained in surplus.
- A shrinking services surplus also played an important role in the current account deterioration. The surplus fell $20 billion between 1981 and 1984. The strong dollar was making traveling abroad relatively inexpensive for U.S. citizens and they were going overseas in much greater numbers. The strong dollar and weak foreign economies also cut deeply into U.S. earnings abroad on direct investments, while payments for foreigners on their direct and financial investments in the United States were growing rapidly. The United States is moving from being a net creditor to a net debtor nation this year, implying U.S. investment income payments will soon be greater than our receipts for the first time in decades.

Anatomy of the Deteriorating U.S. Trade Balance in Manufactures

An unusual confluence of unfavorable circumstances was responsible for the unprecedented $92 billion deterioration in the U.S. manufactures trade balance between 1981 and 1984. The key adverse causes were:

- Rapid economic growth in the United States combined with stagnating or slowly rising domestic demand in Western Europe and Japan.
- The collapse of export markets in LDCs which had been so instrumental in sustaining U.S. export growth during the 1970s. Latin American purchases of foreign goods plummeted as a result of the debt crisis, and the United States was especially hard hit because it has such a large share of that market. Sales to the Persian Gulf countries also fell significantly as those countries could no longer afford to sustain imports, given faltering oil prices.
- The prolonged high value of the dollar. The dollar began to strengthen in the third quarter of 1980, passed its mid-1970s level in 1981, and rose steadily through early 1985. Thus, the dollar has remained exceptionally high for four years. When it peaked in early 1985, the real dollar (after adjusting for differences in inflation) was about as strong as it was during the early 1970s against the yen and most European currencies. It was in the early 1970s that the United States first pressed for a realignment of exchange rates that reversed the deteriorating competitiveness of U.S. goods. The current strength of the dollar against the yen must be considered even more serious than in the early 1970s because of the more formidable competitiveness of Japanese companies.

Figure 17

CHANGES IN U.S. CURRENT ACCOUNT BALANCE BETWEEN 1981 AND 1984

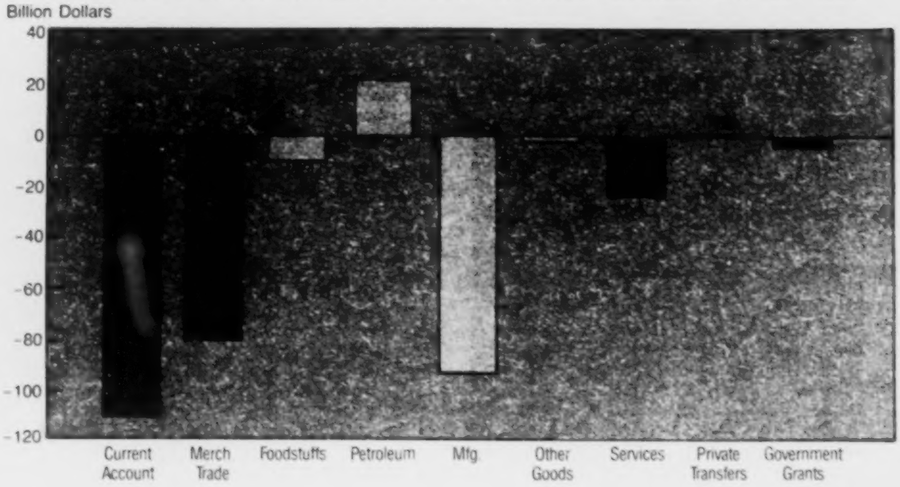
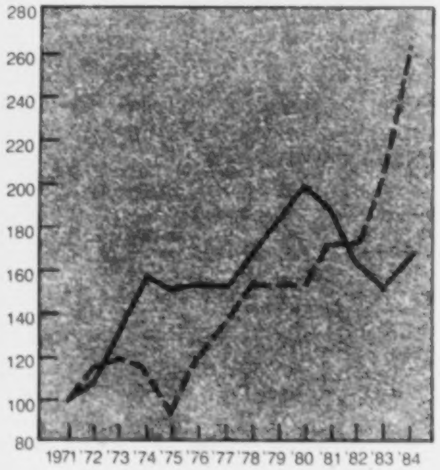


Figure 18

U.S. MANUFACTURES TRADE VOLUME TRENDS, 1971-84

(Index: 1971 = 100)



- The strong movement of Japan and the NICs into manufacturing and exporting a number of product lines (business machines, transistors, VCRs) in which the U.S. market was increasing rapidly.

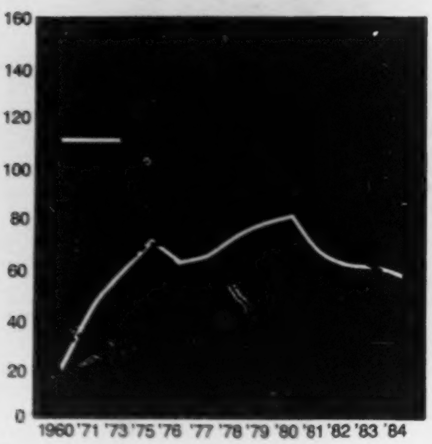
The degree by which each of these factors has influenced the deteriorating U.S. trade balance in manufactures cannot be gauged accurately. They are all intertwined. For instance, it is very difficult to distinguish between the influence of price and availability in creating demand for foreign goods in the rapidly growing U.S. market. Moreover, there are indirect influences. Given the strong dollar, U.S. manufacturers have had to increase their imports of parts and components from the NICs in order to remain price competitive with Japanese and European goods. Most assessments attribute from one-third to two-thirds of the decline in the U.S. trade balance since 1981 to the rise in the dollar. More than one-half would be a reasonable estimate.

But, whatever its share, the dollar's value clearly plays the most important role. The impact of exchange rates on competition can be seen in figure 19, which shows hourly compensation costs for production workers expressed in U.S. dollars. Mainly because of currency variations, German labor costs were 25 percent higher than those in the United States in 1979 and 25 percent lower in 1984. Similar swings can be seen in cost relationships with other major European countries. Although Japan's labor rates never were higher than those in the United States, they climbed to two-thirds of the United States level in 1978 and have

Figure 19

INDUSTRIAL COUNTRIES: HOURLY COMPENSATION COSTS FOR PRODUCTION WORKERS IN U.S. DOLLARS, 1960-84

(U.S. Compensation = 100)



since fallen to half the U.S. level, mainly because of the strong dollar. By comparison, because there has been little change in U.S.-Canadian dollar rates since 1981, Canadian labor costs have remained at about 90 percent of those in the United States. Because their currencies are closely tied to the dollar, the East Asian NICs' labor costs have remained at about 10 to 20 percent of U.S. rates. Mexico and Brazil have brought their labor costs down to a similar range in recent years through sharp devaluations in their currencies against the dollar. Their devaluations have compensated for much more than their high domestic inflation.

To go one step further in looking at price competitiveness, we can add changes in *productivity* as measured by output per hour in manufacturing. We can then gauge the combined impact of labor costs, productivity, and exchange rates through a measurement called "unit labor costs in manufacturing". If one assumes that the exchange rate shifts that took place in 1973 washed out most of the prior price differentials in manufacturing, then through most of the 1970s the United States had a price advantage as measured by unit labor costs (see figure 20). By 1980 or 1981 that advantage was lost to all countries except the United Kingdom. By 1984 the U.S. disadvantage became as large as it was in the early 1970s.

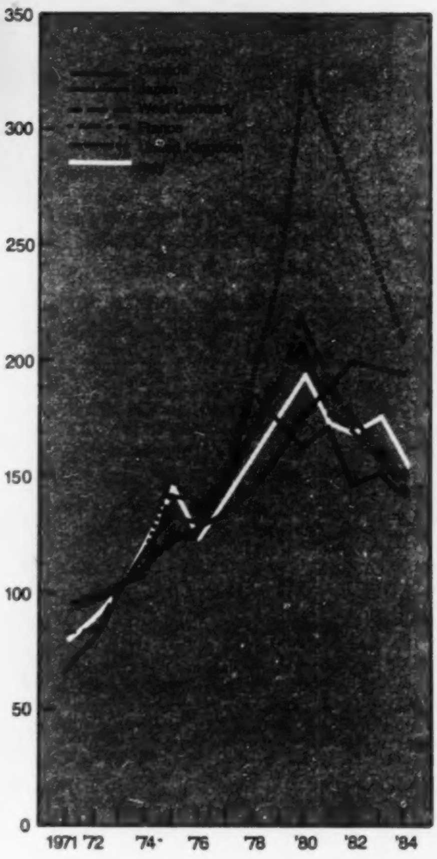
The dollar and other factors had the following npact on the U.S. manufacturing trade balance etween 1981 and 1984:

- A deterioration in nearly all product categories. In a few cases, the declines in the trade balance were especially large; for example, heavy industrial machinery and semiconductors.
- A concentrated decline when viewed by region. Latin America contributed the most (22 percent) to the declining U.S. trade position

Figure 20

INDUSTRIAL COUNTRIES: UNIT LABOR COSTS IN MANUFACTURING, 1971-84

(Index: 1973 = 100)



in manufacturing, mainly reflecting the sharp decline in U.S. exports to the region (see figure 21). In fact, these countries, especially Mexico and Brazil, accounted for nearly 60 percent of the decline in exports to regions in which the United States had falling sales (see figure 22). Most notably, nearly a third of the deterioration of the U.S. balance in heavy industrial machinery was due to faltering sales to Latin America.

- Japan contributed 20 percent of the sliding U.S. deficit as a result of its increased exports to this country. Japan's sales were highly concentrated by product category and made the most sizable contribution to our increased deficit in consumer electronics, business machines, and semiconductors (see figures 23 and 24). Automobiles also had a sizable impact despite the restrictions on the number of units exported to the United States. Japanese manufacturers successfully increased emphasis on their more expensive models and sold an increasing volume of parts. The Japanese did provide one of the best export markets for the United States as they accounted for a quarter of the increases in sales to growing U.S. export markets (see figure 25). Even so, U.S. exports of manufactures to Japan rose only 20 percent between 1981 and 1984, compared with our import growth from Japan of 50 percent. Most importantly, sales to Japan increased from a very small base, reflecting for the first time some success in opening markets through negotiations.

Figure 21

CONTRIBUTION TO DETERIORATION IN U.S. MANUFACTURES TRADE BALANCE, 1981-84

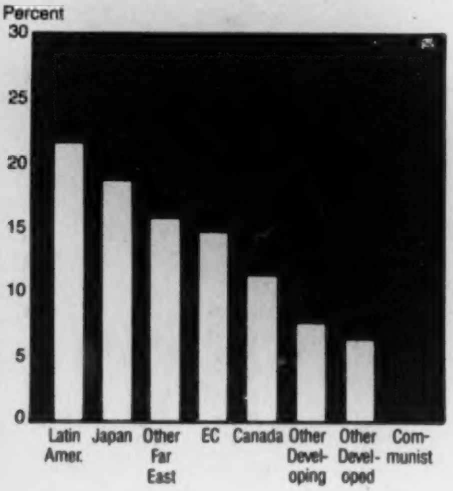
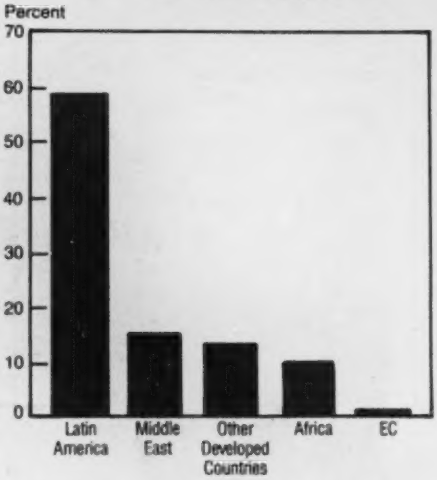


Figure 22

CONTRIBUTION TO DECREASES IN U.S. MANUFACTURES EXPORTS BY COUNTRY/REGION 1981-84



- The Far Eastern countries' (mainly the NICs) contribution to the deteriorating U.S. trade balance was almost as large as that of Japan and followed similar lines. The major difference was that the product mix of Far Eastern NIC sales to the United States was somewhat broader than that of Japan.
- Nearly all the EC impact was on the import side, as U.S. exports of manufactures to the Community remained about the same. The EC did especially well in increasing sales of heavy industrial machinery.
- Although the Canadian contribution to the declining U.S. trade position was also substantial, it reflected mainly automobile trade. That category accounted for about two-thirds of the changing balance in manufactures and more than one-half the increase in U.S. imports of road motor vehicles. With the U.S. and Canadian dollars trading at about the same exchange rate during the past three years and both countries enjoying rapid domestic economic growth, changes in nonautomotive manufacturing balances were rather small.

Figure 23

CONTRIBUTION TO DETERIORATION IN U.S. TRADE BALANCE IN SELECT MANUFACTURES, 1981-84

(In Percent)

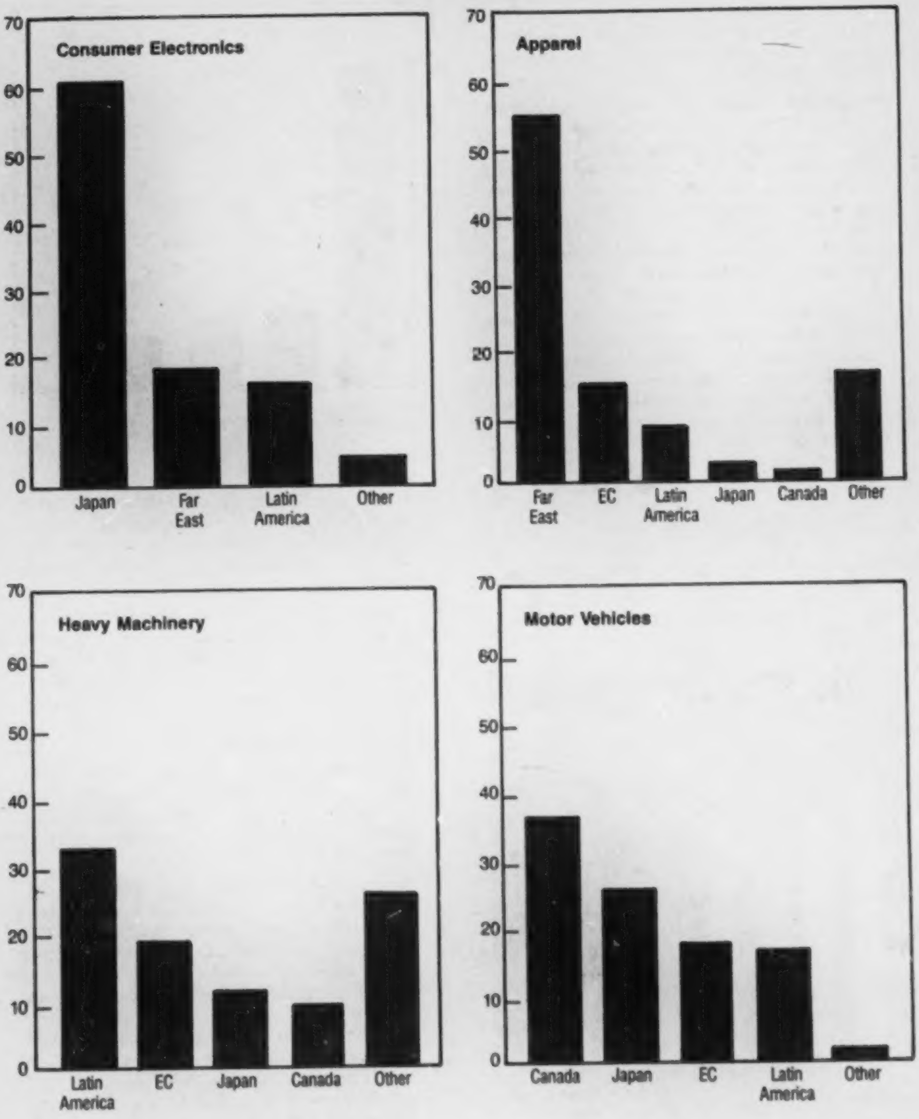
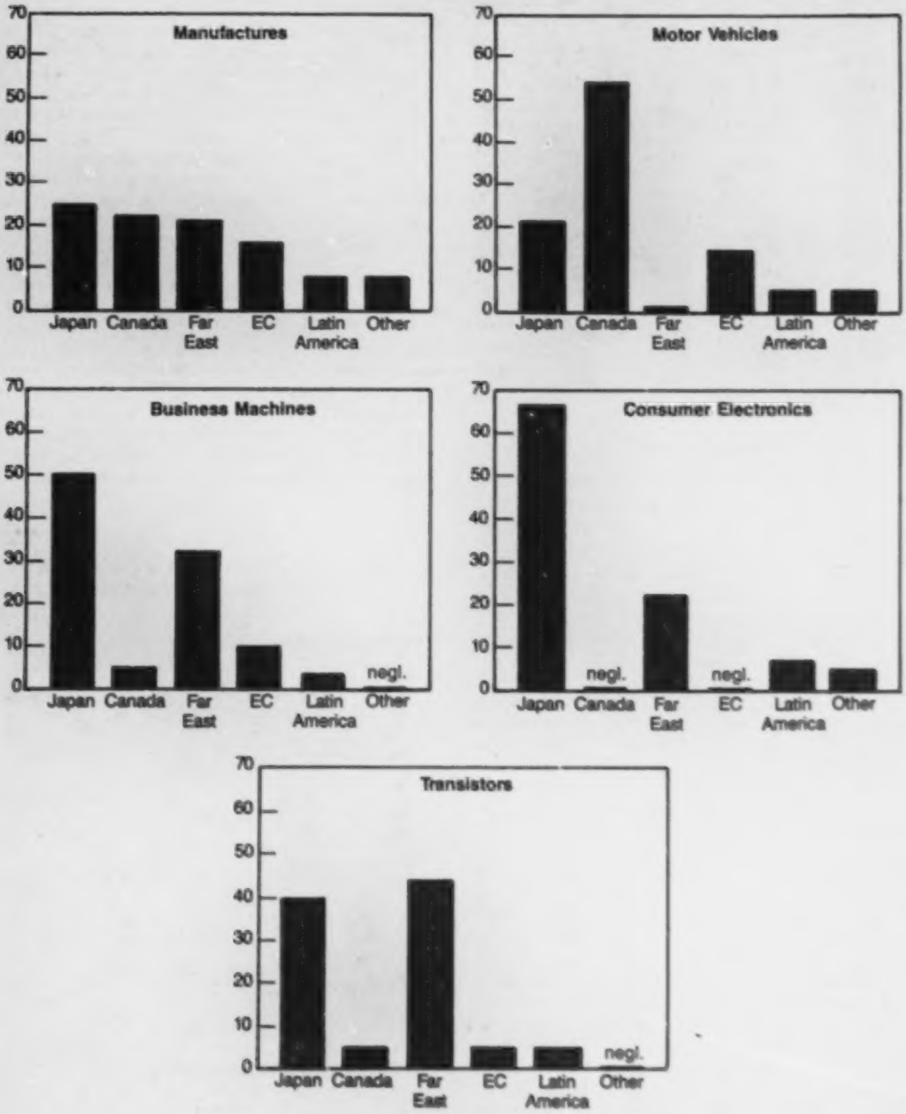


Figure 24

CONTRIBUTION TO INCREASED U.S. IMPORTS OF SELECT MANUFACTURES, 1981-1984

(In percent)



Manufactures

Motor Vehicles

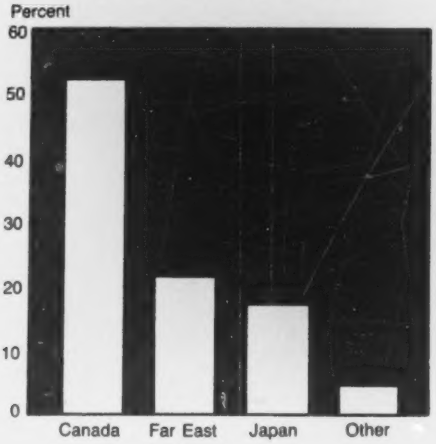
Business Machines

Consumer Electronics

Transistors

Figure 25

CONTRIBUTION TO INCREASES IN U.S. MANUFACTURES EXPORTS BY COUNTRY/REGION, 1981-84



> Those that did occur likely resulted from the ability of non-North American exporters to gain an increasing share of the Canadian market at the expense of the United States.

The declining U.S. trade balance also can be viewed in terms of the U.S. loss of foreign markets and the foreign penetration of U.S. markets.

When measured in value or current dollar terms, the United States maintained its share of industrial country exports of manufactures between 1981 and 1984—about 17 percent. But in volume terms (which is important for keeping plants open and workers employed), the United States lost a substantial 5 percentage points during those three years. This situation is the reverse of the early 1970s, when a declining dollar caused the U.S. market share to decline in value terms and rise in volume. Although the current U.S. share losses occurred throughout the world, they were largest in the Japanese and East Asian NIC markets. Overall, the reduced market shares equalled about a $40 billion loss in potential export earnings in 1984—thus accounting for more than 40 percent of the deterioration of the U.S. trade balance in manufacturing between 1981 and 1984.

Overall import penetration rose rapidly in 1984, reflecting mainly the impact of the prolonged strong dollar. By that year, many U.S. retailers and manufacturers had to turn to foreign products in order to remain competitive. In the dozen years before 1984, the increase in import penetration had been gradual, although in some goods foreigners had made significant increases.

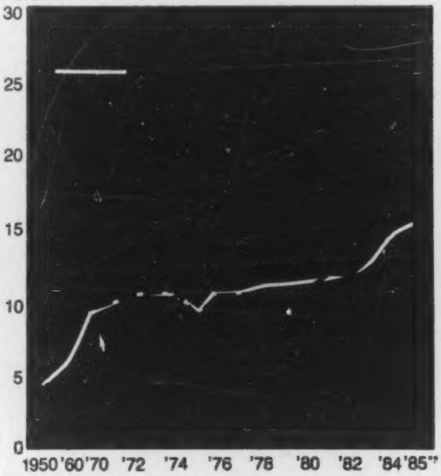
By 1984, real imports had captured nearly 15 percent of U.S. consumption of goods, compared with 12 percent in 1981 (see figure 26). Import penetration, however, varied widely between products from 1980 to 1984. For many products foreign competition has remained minimal; for example, food, tobacco, beverages, pharmaceuticals, cosmetics, chemicals, rubber products, and most major household applicances (refrigerators, etc.).

The most notable inroads since 1981 have been in clothing, leather goods, toys, jewelry, semiconductors, electronic components, mechanical components (such as fans and blowers), and industrial equipment. Import penetration in industrial equipment has risen rather rapidly since the late 1970s, from some 15 percent of real U.S. consumption to near 30 percent in 1985. Some significant inroads can be seen in figures 27 and 28.

For most machinery, it appears that price has not been the most important factor. With U.S. firms spending huge sums on modernizing their production lines, they have turned increasingly to foreign producers, reportedly because of more rapid delivery, better quality products and good service. The increased import share in U.S. electrical machinery purchases reflects an increased

Figure 26

IMPORT SHARE OF U.S DOMESTIC GOODS PURCHASES, 1950-84

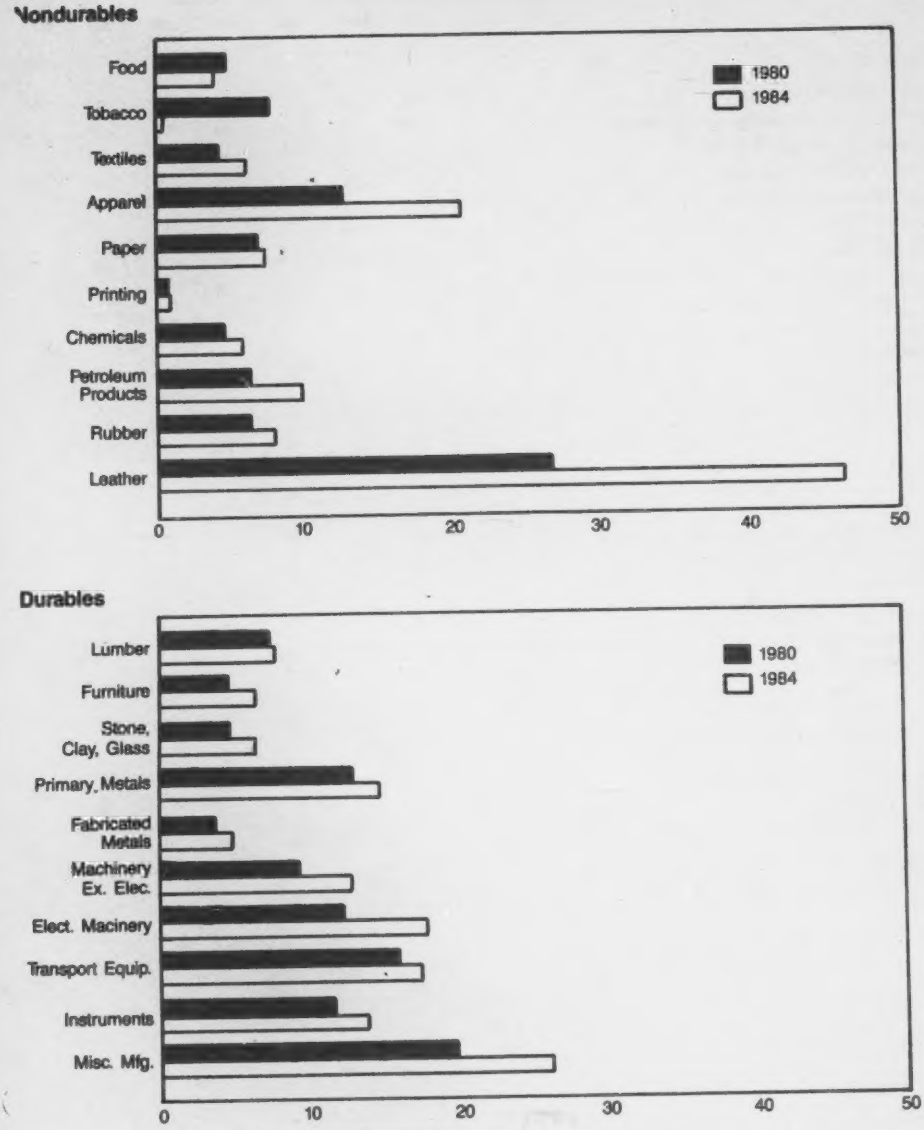


*Excluding autos. **First quarter.

Figure 27

U.S. IMPORT PENETRATION, 1980 AND 1984*

(In Percent)



*Imports as a share of apparent consumption

Figure 28
U.S. IMPORT PENETRATION IN SELECT COMMODITIES, 1972-84*

(In percent)

	1972	1976	1979	1980	1981	1982	1983	198
Machinery								
Metal-cutting machine tools, and parts	9	15	22	23	26	27	32	39
Printing trades machines and equipment, and parts	11	12	18	20	20	23	22	26
Power driven hand tools and parts	9	13	17	18	18	20	21	26
Pulp and paper machinery and parts	15	15	24	23	26	20	18	25
Electric welding machines, electrodes, and parts	2	4	6	9	7	8	11	14
Mechanical Components and Parts								
Fans and blowers, and parts	4	5	10	14	22	20	24	31
Bolts, nuts, screws, rivets, and washers of base metal	8	12	14	13	13	16	16	22
Optical instruments and lenses, and parts	20	19	21	19	20	18	18	21
Pumps and pumping eqipment, and parts	10	9	12	13	13	15	14	18
Tires and inner tubes	8	11	12	13	14	13	14	16
Valves and pipe fittings	4	6	8	8	10	10	9	10
Electronic Components and Parts								
Semiconductors, rectifiers and rectifying apparatus	15	27	31	33	32	34	37	40
Electrical capacitors, fixed or variable	15	23	28	29	27	26	25	32
Resistors for electronic applications	7	13	19	19	21	23	25	32
Apparatus based on x-rays incl. x-ray tubes, or radiation from radioactive substances, and parts	16	23	18	18	17	15	16	15
Electronic components and accessories	4	8	11	11	11	11	11	1.
Chemicals								
Nitrogenous fertilizers	9	10	15	15	14	18	21	22
Inorganic pigments	10	11	14	13	17	17	15	16
Electronics								
Radio, TV receiving sets, phonographs, record players, turntables, audio equipment	37	45	47	48	55	54	55	61
Telephone and telegraph instruments and apparatus, and parts	2	2	3	4	4	6	10	14
Radio and TV communication equipment	4	1	9	9	10	9	9	10
Farm Machinery								
Farm machinery and equipment, and parts	11	12	15	15	13	12	14	16

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* Imports as a share of apparent U.S. consumption.

reliance of U.S. firms on components from the Far East, as well as movement of the most labor-intensive aspects of the production process to that region.

Shifts in U.S. Investment, Productivity, and Employment

U.S. manufacturing firms are now making great strides in improving their ability to compete in global markets. They are achieving increased productivity at home by investing heavily in new equipment and improving the efficiency of their production processes. Much of this upgrading effort is taking place in the newer electronic-based industries rather than in those involved in traditional manufacturing. But even in the traditional industries significant improvements are being made, along with the shedding of older and less efficient capacity.

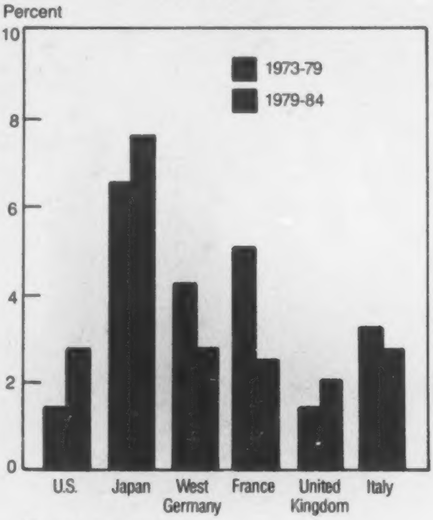
Investments in manufacturing equipment seemed to have gathered steam in the late 1970s, partially in response to the growing foreign competition. Although the prolonged recession and high interest rates ended the investment expansion by 1981, the decline in investment spending was much shallower than during the previous two recessions. New tax incentives for investments were instrumental in avoiding a steeper decline. Investment spending surged in 1984 and, according to Department of Commerce surveys, will continue to advance sharply well into 1985. The 1984-85 rise is more than double the increases that took place in similar cyclical periods during the 1970s. Nearly all the increases in spending have gone into equipment rather than brick and mortar. This has included machine tools, computers for directing the production process, and equipment for better handling the production flow. The increases in investments were across the board, with the largest rises—both in absolute and percentage terms—occurring in automobiles and electrical machinery.

Productivity. This investment surge and the introduction of more efficient production techniques have led to a sizable boost in output per man-hour in U.S. manufacturing. Between 1979 and 1984, that measure of productivity rose 2.8 percent annually, nearly double the rate attained from 1973 to 1979. For the first time in the post-World War II years, the United States has been achieving productivity increases at rates comparable to Western Europe. It remained behind Japan which—mainly because of exports to the United States—had rapidly hiked manufacturing output and was able to achieve increases in output per man-hour manufacturing of 7.5 percent a year between 1979 and 1984 (see figure 29).

Figure 29

INDUSTRIAL COUNTRIES: TRENDS IN MANUFACTURING PRODUCTIVITY, 1973-84*

Average Annual Change



*Output per man-hour

Employment in manufacturing in the United States probably dropped some 10 percent between 1979 and 1984, or slightly more than the increase between 1973 and 1979 (see figure 30). The reversal, however, may be due mainly to a statistical quirk. When a manufacturing establishment hires a contractor to run its cafeteria or guard services, although there are no changes in the work performed, the contractor's employees become classified as "service" workers whereas they were "production" workers when they were company employees. Indications are that manufacturing firms are increasingly turning over to outside contractors many jobs not directly related to manufacturing exaggerating the apparent trend toward service occupations as indicated by official statistics.

Even if there was not much of a secular decline in the number of persons working in production occupations, these types of jobs have declined as a share of total employment. With the total number of civilian workers increasing by 6 percent, the production worker share has fallen 2 percentage points between 1979 and 1984. Also, as expected, most of production labor force reductions occurred in metals and transport industries. Electric machinery and food held their own.

In comparison to the United States, the Euro-

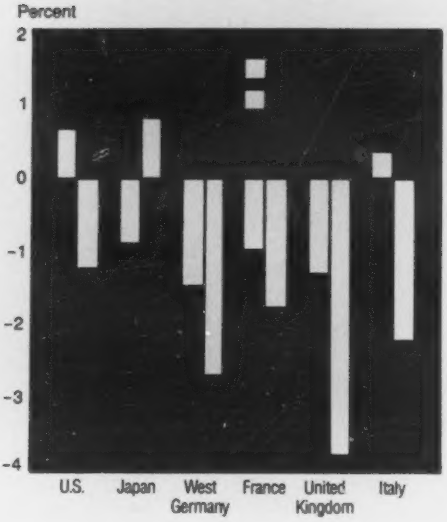


Figure 30
INDUSTRIAL COUNTRIES: TRENDS IN MANUFACTURING EMPLOYMENT, 1973-84
Average Annual Change

pean countries had sizable declines in manufacturing employment as well as stagnant or declining overall employment. Only Japan, with its burst in production, had a slight increase in manufacturing employment, thus reversing the downward trend that had existed since the early 1970s. Since Japanese nonmanufacturing employment rose only as fast as manufacturing, the manufacturing share remained unchanged.

The fortunes of the U.S. manufacturing sector during the next several years will be governed largely by trends in the dollar and in U.S. and global economic trends. Corporate decisions that are now being or have recently been made as to product development, investment spending, plant location, etc. will also play a powerful role. Although the programs put in place over the next few years will be adjusted to meet changing circumstances, these changes will combine to create a momentum that will take many years to reverse.

Economic Trends

More than ever, any examination of U.S. economic trends must consider the international economic forces at work. Although economic interdependence of nations has become a cliche, the linkage of domestic and foreign economic factors cannot be overemphasized. The path and the health of U.S. industry will depend heavily on the duration of the strong dollar, the economic viability of our major trading partners, the magnitude of capital flows in and out of this country, and the adherence of our trade partners to international codes of conduct. And these trends are inextricably linked with U.S. interest rates, the size of our budget deficit, inflation rates, and the commitment to keep our markets open, except when unfair trade practices indicate otherwise. As we have seen, the United States has had a particularly powerful influence on economic expansion elsewhere in the past few years, and the strength of the dollar is having a profound impact on shaping U.S. manufacturing trends.

We are now moving through uncharted waters, battered by a combination of economic circumstances never coped with before. U.S. domestic demand remains the engine of global economic growth while we must contend with an exceptionally strong dollar, high real interest rates, unusually large budget and current account deficits, powerful international financial markets that have minds of their own, a lingering LDC debt crisis, and the possibility of a sharp drop in oil prices. These influences are pulling and tugging the U.S economy, often in different directions. For example, to remain competitive, U.S. industry is simultaneously obtaining more of its products abroad while pouring large sums into making domestic production lines much more efficient. What all this adds up to is an uncertain domestic and international economic climate.

Such economic turmoil has been a hallmark of the years since the early 1970s. Examples include the upheaval in exchange markets as the Bretton Woods arrangements disintegrated, two oil price shocks, an LDC debt crisis, and now a dollar that has remained too strong for too long. In each of these cases, consensus predictions of what happens next were more often wrong than right. In truth, experts and soothsayers most often lack the ability to track trends that are caused by countless individuals reacting to unique sets of circumstances. Indeed, beware of anyone providing a clear view of the future. What can be provided is a sense of the fundamentals that are driving the changes, and some alternative outcomes that now seem plausible.

The Fundamentals

- *The United States cannot continue indefinitely to run huge current account deficits* and thereby pump large amounts of dollars into international financial markets. Sooner or later, investors will refuse to buy dollar-based securities in sufficient quantity to cover our deficits unless interest rates climb sharply. At some point, the resulting higher interest rates will trigger a reduction in U.S. economic activity that will reduce imports enough to cut down the size of the current account deficit to manageable proportions.

- *The U.S. dollar cannot remain at the current strong level.* Sooner or later, the erosion of U.S. trade competitiveness will undermine our economic strength and therefore the confidence of investors in dollar based assets.

Plausible Scenarios

The key question then becomes: "What are the plausible paths toward reaching a manageable current account position and a competitive dollar?" A few possibilities are sketched below:

- *The dollar declines gradually—the so-called "soft landing".* In this scenario, domestic demand in Western Europe and Japan accelerates, topping the U.S. expansion. Meanwhile, industrial world real interest rates drop in recognition that inflation is being held in check. The fall in interest rates is helped by a continuous cut in U.S. budget deficits which reduces the need to attract foreign funds. European and Japanese currencies appreciate against the dollar as investors react to a more even distribution of economic growth and reduced interest rate differentials among countries. The debt-ridden LDCs also focus their export attention on the faster growing non-U.S. industrial country markets, and U.S. sales to these LDCs pick up since they can afford more imports as a result of lower interest rates.

  All these factors lead to a narrowing of the U.S. trade deficit. Most observers see the process as gradual; that is, taking four or five years to reach a more reasonable outcome in terms of the current account and dollar. Under this scenario, the worst that could happen during these years would be a temporary slowdown in U.S. and global economic activity.

- *The strong dollar persists for two years or so.* Under this scenario, the United States and other industrial countries expand at near the same rate. Mainly because of a continuing strong dollar, the U.S. trade deficit continues to grow although not as fast as in 1983 and 1984 when economic growth rate differentials and the collaspe of the LDC market also played an important role. According to some estimates, the U.S. trade deficit would reach $200 billion by the end of the 1980s. Our current account deficit, however, would approach that level much sooner because our "services" surplus would turn negative as the United States becomes a sizable net debtor nation.

  With the U.S. net debt increasing somewhere between $125 and $200 billion per year, the point would be reached in a few years at which foreign investors would refuse to buy dollar assets in sufficient quantity to maintain dollar strength. The dollar might then fall very deeply—perhaps to levels well below anything in recent history—to overcome the distortions in our industrial base that would have resulted from an excessively strong dollar for more than half a decade. Some fear the quick move out of dollars under such a dollar decline scenario could create great dangers to the viability of the international financial system.

- *The dollar plummets within the next six months.* Expectations of a weakening U.S. foreign financial position and domestic economy could push the dollar toward a free fall, cutting perhaps 40 percent off its value. The immediate problem would then be the difficulty in attracting sufficient foreign funds to finance the budget deficit. This might be possible only if interest rates are raised sharply, a factor that would depress the U.S. economy. In this circumstance, the only way to avoid a recession would be to cut the budget substantially or to pursue inflationary policies, either of which would have an adverse economic impact.

- *The dollar declines substantially within a year as a result of a recession.* In this scenario, distortions to the U.S. industrial base caused by the strong dollar are already leading to a recession. Once the recession becomes apparent, the dollar could weaken and our current account deficit narrow. The reduced domestic demand would result in falling imports. Our sales to other countries would be hurt, however, because their economies would suffer from faltering export sales to the United States. But these lost exports could be made up once the reduced dollar boosts U.S. market shares abroad—probably beginning six months or so after the dollar falls significantly.

The last two plausible scenarios create a policy quandary as a result of a recession that could produce a budget deficit that some believe might top $300 billion. Relatively high interest rates would be needed to attract the funds needed to finance the huge budget deficits. The high interest rates, however, would only make the recession worse while keeping the dollar too strong. The only possible alternatives would be a sizable cut in the budget deficit—a harsh remedy during a recession—or a return to the inflationary policies of the 1970s. The latter would result in negative interest rates, allow for inflating away debt problems, and help temporarily to avert a deep recession. Within a year or two, however, such policies would create new problems which could be resolved only through much economic distress.

The Impact on U.S. Industry

Obviously, the sooner and faster the dollar falls, the quicker the seepage of U.S. industry abroad and the penetration of U.S. markets would slow.

As we have seen, a strong movement overseas is beginning to take place. While it is impossible to quantify these trends precisely, my discussions with businessmen and other recent evidence indicate the outflow could remain very high for years because many U.S. firms now believe the dollar will remain high for some time. If their assumptions turn out to be right, U.S. investment abroad in manufacturing is likely to remain strong for many years. Only a global recession would likely halt the trend.

There also appear to be strong indications that an increasing number of U.S. firms are dismantling all or parts of their overseas marketing and servicing organizations. The impact seems most striking in industrial machinery, where business has been hurt by a strong dollar, improved foreign capabilities, and a slump in LDC markets. Many more of these facilities will likely be pruned in the face of a continuing strong dollar. Moreover, if economic activities abroad remain in the doldrums, companies would probably close additional foreign export-related operations. Once these organizations are shut down it will be years before they can be restored. Thus, even after the dollar does decline and foreign economies improve, U.S. exports can be expected to rebound much slowly than usual.

The purchase of foreign parts and components is reversible more quickly. Many U.S. firms prefer to have their suppliers close at hand in order to allow them to more quickly change product design and to ensure better control. Thus, if a weaker dollar allows U.S. manufacturers to obtain the necessary components and parts at home and still compete with other industrial countries, they probably will do so. The longer the dollar remains high, however, the more entrenched relations with foreign suppliers will become and the longer it will take to reverse import reliance. It should be reiterated strongly that the inroads made by NICs in the finished goods market in the United States will be little affected by the value of dollar, since these countries essentially peg their currencies to the dollar.

As important as the trends in foreign procurement and overseas investments may be, I believe the strong dollar has resulted in an even more significant change in overall U.S. corporate strategies toward international competitiveness. I see many large U.S. companies moving more rapidly away from export-oriented strategies to approaches that are more transnational in scope. Although, as with any emerging trend, the evidence will remain anecdotal and fragmentary until the pattern becomes well established, my experience, unpublished surveys I have seen, and discussions with business leaders give me a strong sense about this change.

Constantly faced with growing foreign competition and major import barriers, and buttressed by growing belief that the dollar will remain strong (if not erratic) for some time, many U.S. corporations feel they must better hedge their competitive strategies. As a result, companies are placing much greater emphasis on achieving a market presence in foreign countries through establishing overseas plants, entering into joint ventures with local companies, licensing their technology abroad, and entering into reciprocal marketing arrangements with foreign firms in the same field. Foreign companies also seem to be emphasizing similar strategies; witness the large and growing direct investment by foreign firms in the United States, even though the high dollar makes such investments especially costly.

From the U.S. perspective, I see the strong dollar thus greatly speeding up the inevitable internationalization of markets. The result will be that each nation will have less control over its manufacturing companies, and new frictions will arise when companies' global interests clash with national interests. My fear is that national governments trying to retain power will take steps that will greatly hinder the further advancement of global prosperity produced by growing trade.

Senator **Sarbanes**. Thank you, Mr. Olmer. Mr. Holtham, please proceed.

STATEMENT OF GERALD HOLTHAM, VISITING FELLOW, THE BROOKINGS INSTITUTION, AND FORMER HEAD, GENERAL ECONOMICS DIVISION, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, PARIS, FRANCE

Mr. **Holtham**. Thank you very much, Mr. Chairman and members of the committee. I should like to say how very pleased and privileged I feel to be asked to come and testify here, and I would like to start with an apology that I don't have for you a prepared statement. I do understand that some copies of an article which I have recently written are available to you, and I am going to speak to the issues in that article, but I am afraid I haven't anything new on paper, owing to the short notice with which I was asked to come.

[The article by Mr. Holtham follows:]

A Case for International Coordination of Monetary Policy

Gerald Holtham

OVER THE PAST five years the U.S. economy has become seriously out of balance. The federal budget deficit equals nearly 5 percent of gross national product in 1986; the associated deficit in the balance of payments current account is over 3 percent of GNP. The United States, which became a net debtor country in 1985, is on the way to becoming the world's biggest debtor. Borrowing from foreigners to finance the twin deficits is at interest rates higher than the growth rate of nominal GNP, an unsustainable situation. Meanwhile economic growth in the United States has fallen to little more than 2 percent a year.

The Reagan administration believes that the Europeans and Japanese could ease the United States' economic problems by stimulating their own domestic demand growth. Hence the public exhortations by both Treasury Secretary James A. Baker III and Federal Reserve Chairman Paul Volcker to other countries to change policies.

Generally, since September 1985 when the five largest Western economies agreed to cooperate to lower dollar exchange rates, Secretary Baker has been a vigorous promoter of international cooperation. His efforts appeared to bear some fruit at the end of the Tokyo economic summit last May when the heads of state of the same five countries agreed to seek closer cooperation. Subsequent practical measures, however, have not been forthcoming. The second and third largest Western economies, Japan and West Germany, are resisting Baker's arguments for stimulatory policies.

There is a very strong case for a measure of international coordination of monetary policy, as will be argued below. But actions by other countries cannot substitute for determined policy action by the United States. In the absence of a substantial reduction in the U.S. budget deficit, no policies that foreign economies are likely to undertake would have more than a marginal impact on U.S. growth and trade. Therefore, the prospects for longer-run cooperation should not be sacrificed to an attempt to get other countries to bail out the United States through an immediate stimulus.

U.S. Imbalances: Can Foreigners Help?

What would be the impact on the U.S. economic outlook if other member countries of the Organization for Economic Cooperation and Development (OECD) were willing to adopt policies to increase their domestic demand? A recent conference hosted by the Brookings institution assembled simulation results from a dozen international econometric models bearing on this and related questions. One conclusion that emerged is that the type of expansion matters: foreign fiscal and monetary policies have quite different effects on the United States.

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Fiscal Effects

Substantial consensus existed among the models about the short- and medium-term effects of fiscal policy. Model results, backed up by an examination of trade shares and patterns, suggest the following. If all OECD countries except the United States somehow increased their GNP by 1 percent and if exchange rates stayed the same, the resulting boost to U.S. exports could raise U.S. GNP by about a fifteenth of a percent in the first year. A fiscal expansion in foreign countries equivalent to 1 percent of their GNP would increase their GNP by a little more due to the multiplier effect. It would also tend to push up foreign interest rates and so depreciate the U.S. dollar, raising the first-year effect on U.S. GNP to perhaps a quarter of a percentage point. That effect would decay over time, roughly halving over three years. If countries with chronic public deficits, like Italy, abstained, leaving the stimulus to a few countries like Japan and Germany, the effect on the United States would be even smaller.

This level of stimulation, while marginally useful, would not decisively alter U.S. growth prospects. Nor would fiscal action have a great impact on the U.S. external deficit. The model simulations suggest that a fiscal boost in the rest of the OECD nations equal to 1 percent of their GNP would improve the U.S. current account balance by something in the range of $3 billion to $12 billion after two to three years. (The average result was about $6.5 billion.) The current account deficit in the first half of 1986 ran at an annual rate of around $130 billion.

"Without corresponding action on the part of the Federal Reserve, a monetary relaxation abroad might not help the United States at all."

In 1983–84, when the United States acted as a "locomotive" to the world economy, its domestic demand grew at an annual rate of over 8 percent. To generate a comparable stimulus for the world economy, Japan, Germany, and France, given the smaller size of their economies individually, would all need to expand their domestic demand together at an annual rate of 8–10 percent. Action on any such scale is beyond the bounds of political feasibility.

Monetary Effects

Without corresponding action on the part of the Federal Reserve, a monetary relaxation abroad might not help the United States at all. The reason is this. A fiscal expansion, by increasing the demand for credit and thus raising interest rates, can appreciate the currency of the country taking fiscal action, which in turn attracts imports and spreads some of the stimulus abroad. But a monetary expansion tends to lower interest rates, thereby depreciating the currency and helping to bottle up the expansion at home. In short, the United States might lose more from the resulting appreciation of the dollar than it would gain from the greater domestic demand in these nations that decided to undertake a monetary expansion.

Considerable diversity about the effects of monetary expansion in other OECD countries existed among the models represented at the Brookings conference. Some had positive spillovers on U.S. GNP and the current account balance; others were negative. Net effects, however, were usually small. Given the current state of knowledge, it is reasonable to conclude that there is little or no direct effect on, certainly no substantial direct benefit to, the United States from monetary expansion abroad.

To reduce the U.S. trade deficit, therefore, there is no alternative to policy action in the United States. In particular, substantial cuts in the federal deficit would restore the national savings/investment balance, further reduce real interest rates, and promote further depreciation of the dollar. However, U.S. budgetary action would have other significant consequences at home and abroad.

Domestic Effects of U.S. Deficit Cuts

The depreciation of the dollar that has already occurred is expected to improve the U.S. trade balance in the months ahead. That and the fall in oil prices, which will leave extra money in consumers' pockets in all industrialized countries, are expected to quicken U.S. growth late this year and early next—despite an assumed domestic fiscal contraction due to deficit reduction. By mid-1986 there were few signs that this acceleration had begun. Yet more problematic is what will happen late in 1987 and into 1988 if the boost from oil prices fades while successive rounds of retrenchment in the federal budget remain to come.

Long-term U.S. interest rates and the dollar both declined in 1985, apparently because the market believed that Congress and the administration would find some way to get control of the federal deficit. If congressional action continues to reinforce market belief that the deficit will be reduced, long-term interest rates could fall further in anticipation of reduced federal credit demands and lower growth rates. Lower interest rates would help to support economic activity. So would further depreciation of the dollar and the improved net exports it would bring. The historical record is fairly clear, however, that those automatic stabilizing mechanisms would not entirely cancel the short-term contractionary effects of government spending cuts or tax increases. (In the longer run lower deficits should foster growth through lower interest rates and a higher share of productive investment in GNP.)

What would be the effect on U.S. GNP if Congress made a cut in U.S. government expenditures equal to 1 percent of GNP and the Federal Reserve did not take specific action to counteract that fiscal contraction?[1] Averaging the available econometric model results yields a predicted reduction in GNP of 1¼ percent in the first year after the reduction. The economy's self-correcting properties slowly remove this effect. But after three years, GNP would still be almost 1 percent below what it would have been without the fiscal contraction. Many models simulate substantial effects persisting for six years.[2]

Suppose Congress wants to hit Gramm-Rudman-Hollings targets and assumes the economy will grow at 3½ percent a year to 1990. That supposition implies a fiscal policy of reducing government expenditures (or raising taxes) by 2½ percent of GNP over 1987–89. However, without offsetting action by the Federal Reserve, such cuts could reduce economic activity substantially. GNP could be about 1¾ percent below the 3½ percent growth path in 1987, some 2¾ percent below in 1988, and perhaps 2¼ percent below in 1989. If monetary policy and other factors could not keep GNP growing at 3½ percent a year in the face of such contractionary impulses, the Gramm-Rudman-Hollings targets could not be met. Still larger spending cuts would be needed. If they were made, still slower growth would be inevitable.

Using monetary policy to offset fiscal retrenchment is a very delicate operation. The effects of monetary policy are more uncertain, and the lags before they are realized may be longer than the lags for fiscal policy. This conclusion is supported by the simulations presented to the Brookings conference. There was much less agreement among participating international econometric models about the effects of monetary policy than about those of fiscal policy.

Because of uncertainty and possibly long lags, it would be easy to underestimate the eventual effects of monetary policy when faced with the evidence of modest short-run impacts. The monetary policy stimulus necessary to offset a fiscal contraction in the short run could cause inflation later. Fearing this longer-run outcome, markets may become nervous at a vigorous monetary stimulus, triggering a run on the dollar, which itself would lead to accelerating inflation. This outcome has been predicted regularly ever since the Federal Reserve relaxed policy somewhat in 1982. The inflation has yet to happen, but Volcker's reticence about the necessity for further declines in the dollar probably reflects his awareness of the risk.

Foreign Consequences of U.S. Deficit Cuts

The economic recovery of Europe and Japan from the 1982 recession occurred largely because the United States proved to be a ready market for their exports. If the United States moves into recession in 1988, can they avoid recessions of their own without changing policies?

If only the direct linkages through trade are examined, it appears that the answer is yes. European and Japanese prospects, however, would be bleak enough. And that is without taking into account the developing countries' debt crisis, which is aggravated by any substantial slowing down in the growth of the industrialized countries and so threatens to magnify the deleterious effects of any such slowdown.

Consider again the simulated effects of a U.S. fiscal contraction equal to 1 percent of U.S. GNP. According to an average of model results, the impact on the rest of the OECD countries was estimated to be about a quarter of a percent of GNP in the first year, rising to four-tenths of a percent in the third year. So if the Gramm-Rudman-Hollings targets were reached, the effect in the rest of the OECD countries might be to reduce their GNP by around a third of a percent in 1987, by more than half a percent in 1988, and by nearly 1 percent in 1989. The effect might well grow for some years thereafter.

Even if the United States succeeded in offsetting the contractionary effect of its fiscal policy by a monetary expansion, so avoiding domestic recession, its action would be unlikely to help other countries. That is because of the asymmetry, already noted, in the foreign spillover effects of monetary and fiscal policies. The fiscal contraction would hurt activity in the rest of the world, while an offsetting monetary expansion might not help, as it would depreciate the dollar still more.

On balance, then, growth in the rest of the OECD in the next few years could be a quarter to a half a percent slower because of U.S. deficit reduction. The effect on countries like Japan and Canada, which are particularly dependent on U.S. markets, would be greater; the impact on most European countries would be somewhat less. These numbers are not large, especially when the uncertainties surrounding the estimate are taken into account, but they would be bad news to economies already growing slowly with high and steady unemployment. Nor do they take account of financial turbulence that could be induced if slower OECD growth aggravates the Latin American debt crisis.

Foreign Growth: Already Too Slow

Between the cyclical peaks of 1973 and 1979, the two largest European economies, Germany and France, grew at annual rates of 2⅓ percent and 3 percent respectively. During that period, capacity utilization in the manufacturing sector, as revealed by business surveys, fell by two percentage points in Germany and by three and a half percentage points in France. Meanwhile unemployment tripled to 3 percent in Germany and to 6 percent in France.

In the 1980s European growth has been even slower than in the devil's decade of the 1970s with its oil shocks and rapid inflation. Since 1980 inflation has dropped, profits have recovered, and real oil prices have declined, so it is difficult to believe that the potential growth of the European economies is now below 1970s trend rates. If the growth trends of the 1970s are extrapolated (and they are a conservative estimate of potential growth), GNP is now more than 5 percent below the trend line in Germany and more than 7 percent below in France. Unemployment in both economies has more than doubled since 1980 and shows little sign of decline. All these facts strongly suggest that, even if their maximum full-capacity (potential) growth over the very long run is only 2½ percent, these economies have enough slack to let them grow at 3½ percent a year for at least five years without any excessive pressure on resources. If they are to make any inroads on their serious unemployment problem, they need to do so.

In the first half of 1986 both economies grew at an annual rate below 2½ percent. Both the International Monetary Fund (IMF) and the OECD forecast that Germany's growth will accelerate to above 3 percent in the second half of 1986, but it is far from clear that a growth rate of 3½ percent will be reached, let alone sustained. Meanwhile, few forecasters expect the French economy to achieve even 3 percent

U.S. Policy and World Saving

Opponents of an expansionary fiscal policy in Japan and Europe often employ the argument that the world is short of saving. It is scandalous enough that the United States, the world's largest developed economy, should be soaking up the savings of others to finance its deficit, they say. What is the good of the United States putting its house in order if other rich countries start spending more relative to what they produce, reducing the available investment funds for developing countries? So goes the argument.

But that argument is seriously flawed. That the United States needs to reduce its budget and external deficits is not in dispute. On all past evidence, however, such a reduction would not be sufficient in itself to see a smooth redirection of world saving to other countries, and, in particular, to the developing countries. Furthermore, it is quite wrong to analyze the world economic situation as if output levels were immutable.

When the net demand for funds in the United States falls as the domestic saving/investment balance is restored, it is probable that the exchange value of the dollar rate will decline, reducing net imports. And as foreign countries face declining demand for their exports, their level of demand and output will be affected. World interest rates should decline, but lower rates will not be sufficient to maintain world output unchanged.

If countries like Japan and Germany want to maintain existing levels of output and saving but can no longer export saving at the same rate to the United States, they have, in principle, two choices. They can either invest more domestically to build up capital stock at home, or they can lend to countries other than the United States that can productively invest their savings to earn a higher rate of return.

Neither option is easy to achieve. In a market economy there is no foolproof way of raising the investment rate of the private sector. The most reliable way to raise domestic investment historically has been by judicious stimulation of demand, so raising levels of capacity utilization.

Nor is there any politically feasible scheme in sight to direct exports and credits on a larger scale to developing countries. The private sectors and particularly the banking sectors of industrial countries are currently very cautious about lending to debt-ridden developing countries despite the relative shortage of capital in those countries, which, in principle, implies that investment there should earn a high return. If the United States reduces its current account deficit but the developing countries are unable to increase their deficits because of their poor credit ratings, it follows that countries like Germany and Japan cannot continue to run such large current account surpluses. Domestic investment must replace exports if German and Japanese savings are to be kept up. And some sort of domestic expenditure must replace exports if the growth of output and employment is to be kept up.

growth in the immediate future.

The situation in Japan is similar. Trend growth there in the 1970s was over 4 percent a year. Unemployment increased, though remaining low by international standards, and reported capacity utilization rates fell. Led by export growth, the Japanese economy grew at above 5 percent a year in 1984 and 1985. Fueled by the U.S. expansion, Japanese exports rose at an annual rate of 17½ percent in 1984, and by nearly 6 percent in 1985. Domestic demand in Japan grew at less than 4 percent. Now as the export boom fades because of slow U.S. growth and a substantial appreciation of the yen, the Japanese economy has slowed too. GNP stagnated in the first quarter of 1986 and seems likely to have grown at less than 3 percent in the first half of this year. Even with the aid of falling oil prices, Japan, according to many forecasters, will not register a 4 percent annual growth rate in either 1986 or 1987 on current policies.

Fiscal Expansion Unfashionable Abroad

The case for expansionary policy in Europe and Japan can therefore be made purely in terms of their own situations. It is not necessary to invoke the benefits for exports and the debt-servicing capacity of developing countries nor the (marginal) contribution to U.S. adjustment that such a policy would yield. Yet the larger European countries and, to a lesser extent, Japan are unwilling to consider any substantial changes of macroeconomic policy. Certainly concerted changes on the scale necessary to add a sustained 1 percent a year to the growth of their domestic demand, for example, are out of the question. Why?

Essentially, there are two reasons. First, a strong school of thought in these countries does not believe that any durable increase in activity can be achieved by macroeconomic policies, fiscal or monetary. American economists are schizophrenic on this issue. They teach that economies are stable and tend to return automatically to a "natural" unemployment rate that cannot be influenced by macroeconomic policies. Yet they are ready pragmatically to propose such policies to influence the level of demand when economies are clearly growing at below trend rates with substantial margins of spare capacity. Even so, such stimulatory policies are widely thought to have only a temporary effect. European policy-makers tend to believe the level of activity is supply-determined, and they fear that an expansionary fiscal or monetary policy would only temporarily boost economic activity but cause permanent increases in public-sector deficits or inflation.

The second reason, especially in Japan and Germany, is a deep-seated concern about public deficits. In the 1970s the budget deficits of those two countries grew considerably, largely because of the operation of the automatic stabilizers, which tend to worsen the deficit as the economy slows down. The budget in each country went from a surplus in 1973 to a deficit of about 4 percent of GNP by the end of the decade. Yet, as we have seen, the automatic stabilizers did not prevent a decline in capacity utilization and a rise in unemployment.

The deficit problems in both countries were exacerbated by the second oil price rise and the policy responses of almost all industrialized countries. To combat inflation, industrialized countries followed the tight-money approach of the United States, driving real interest rates to record heights, which helped to precipitate a recession and throttle inflation. Consequently a lot of public debt was issued at historically high real interest rates, and the interest burden of public debt was greatly increased.

Germany and Japan undertook programs of budgetary retrenchment, reducing their deficits to around 1 percent of current GNP. Budgets, apart from interest payments, are back in surplus, and if GNP were at trend levels, the actual budget would again be in surplus because of the automatic stabilizers. Thus structural, or noncyclical, deficits have been eliminated in both Japan and Germany. A consequence of retrenchment has been a sluggish recovery from the 1982 recession, with much of what growth there has been coming from exports. Nonetheless both governments now prefer to sit it out; neither wants to risk a return to public-sector deficits with a fiscal expansion.

"At current levels of unemployment, which cry out for an acceleration in growth, such high real interest rates are unjustifiable."

The position is held with greater vehemence in Germany where it is abetted by a general fear of inflation on the part of the electorate and a consequent tolerance of slow growth. In Japan the government itself recognizes a potential growth rate of 4 percent. Growth below that rate for any extended period would set up pressures for a change of fiscal policy.

Current policies in Germany and Japan are fortified by another consideration. In both countries, demographic trends foreshadow an aging of the population with predictable implications for pensions costs on the basis of current commitments. (In Japan the problem is compounded by the immaturity of the pension system.) If other elements of fiscal policy remain unchanged, public borrowing will have to rise just to cover social security obligations. As a result, the ratio of government debt to GNP could rise after 1990 and rise steeply after 1995. Consequently neither government is eager to incur any avoidable debt in the meantime.

Monetary Expansion?

European countries and Japan could seek to maintain or increase the tempo of economic activity by reducing short-term interest rates. If markets believed that short-term interest rates would be durably lower, long-term rates would fall too. Neither Germany nor Japan has any inflation to speak of, and they are not growing fast relative to potential, so an easing of credit conditions could not plausibly be expected to lead to an outbreak of inflation. Interest rates have declined since 1984, but long-term interest rates are still around 5–6 percent in Germany and Japan. Even if inflation quickens to the range of 1–2 percent a year in those countries and is expected to stay there, real interest rates would still be above the trend growth rate and certainly above currently forseeable growth rates. At current levels of unemployment, which cry out for an acceleration in growth, such high real interest rates are unjustifiable.

Of course the declared monetary strategy of the Japanese and many European governments is to focus not on interest rates but on monetary aggregates. That procedure is more stable in economies facing nonmonetary shocks. It loses some advantages, however, when the relationship among money, prices, and economic activity is unstable or uncalibrated.

For example, the target ceiling on German monetary growth of 5½ percent a year seems adequate to accommodate 2 percent inflation and 3½ percent real growth, until it is recalled that the income velocity of the targeted aggregate (Central Bank Money) has been falling in Germany for years. The rate of decline in velocity since 1973 has been about 1½ percent a year. If that trend goes on, the top of the German target range for monetary growth "leaves room" for nominal income growth of only 4 percent a year. If reducing interest rates led to some overshooting, therefore, there need be little cause for concern. In particular, the Bundesbank's reputation for being concerned about inflation seems likely to survive the experience.

Lower interest rates and faster money growth could well happen if growth continues to be slow. There may be some reluctance to reduce interest rates because the size of the boost to world growth from lower oil prices is an unknown and controversial matter. It is possible that growth will be quicker in 1987 than many now predict. Some governments would prefer to wait until next year to see how things go and then ease monetary policy if need be.

The Need to Cooperate

Secretary Baker has told the Japanese and Europeans that the only way the United States trade deficit can be slashed is if the dollar depreciates further or their economies grow faster. Yet they are reluctant to take decisive action to stimulate domestic demand growth. And even if they did, the effect on the U.S. trade deficit would probably be only marginal. Through monetary policy, the Federal Reserve has considerable influence over both U.S. economic activity and the dollar's exchange rate. That being so, the administration may be tempted to abandon seeking cooperation from other countries and concentrate on having its way with the Federal Reserve. That would be a grave error. The current world economic situation carries two opposite dangers. The world is traveling a road with a deep ditch on either side; the risk of falling in one or the other is much greater if monetary policies are not coordinated internationally.

The first danger is that there may be a recession if policymakers in different countries cannot predict each other's actions and all err on the side of caution. A faster U.S. monetary expansion, if other countries do not ease their monetary policies, could cause the dollar to plummet too far too quickly. That risk may inhibit the Federal Reserve from acting vigorously enough to stave off recession in the United States. So far, that sequence of events has not occurred, but the real test may lie ahead — in 1988, if Congress follows a policy of progressive deficit reduction, as it should. If the Fed is inhibited and at the same time foreign governments retain their reluctance to stimulate their own demand growth, the world could slip into recession.

The converse danger is an inflation caused because countries do not take account of each other's policies. A set of policies, each of which makes sense in isolation, can add up to collective error. The United States could permit a rapid expansion of credit to avoid a prospective recession, while other countries respond vigorously with monetary expansion to avoid an appreciation of their currencies. These actions could lead to renewed worldwide inflation — the mirror image of the early 1980s when a general but uncoordinated monetary contraction led to a deeper recession than anyone expected. There is some evidence that world slumps and inflations over the past 20 years have been linked with variations in the U.S. money supply coupled with parallel movements in foreign monetary aggre-

> *"Conditional agreement — committing the parties to do something if stipulated events occur and if agreed indicators fall within specified ranges — may be the only way to secure timely coordinated policy responses and to minimize the danger of either recession or inflation."*

Conference on Econometric Models

The Brookings conference, held on March 10–11, 1986, entitled "Empirical Macroeconomics for Interdependent Economies: Where Do We Stand?" had two objectives. One was to evaluate the current state of the art of empirical modeling of economic interactions among the larger industrial economies. A second was to explore the implications of the current policy mix in the United States on the dollar and on foreign economies and the feedback effects on the United States of policy actions abroad.

Twelve prominent multicountry econometric model teams took part in a preliminary workshop and prepared a set of simulations based on common assumptions. Models from national government agencies, international (intergovernmental) organizations, commercial consulting and forecasting firms, and academic institutions were all represented.

The exercise was part of a Brookings research program on macroeconomic interactions and policy design for interdependent economies, financed by grants from the National Science Foundation and the Ford Foundation. The proceedings of the conference are expected to be published next year.

This article makes use of the author's interpretation of the results generated by the participating models. The modeling groups cannot be held responsible for this interpretation of the conference results.

INFLATION
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gates as countries resisted exchange-rate changes. It is essential, therefore, that monetary policy be internationally coordinated in the years ahead.

The overall stance of monetary policy in the OECD as a whole should be appropriate in the light of current forecasts of real growth and inflation in the world economy. At the same time, relative monetary policy settings should not make it difficult for exchange rates to settle at levels consistent with equilibrium in external current accounts. For example, a relative tightening of U.S. fiscal policy, compared to that of other countries, in the years ahead should tend to bring about some further decline of the dollar, leading to a more sustainable pattern of world current balances. Relative monetary policy settings should not impede that dollar depreciation.

What do these risks mean for the conduct of international economic discussions in the immediate future? First, there seems little payoff in getting into official arguments about fiscal policy. Second, because the immediate growth outlook is uncertain and there is some possibility that OECD growth could accelerate out of current sluggishness, it is more important at this stage to work out the principles of international monetary coordination than to argue about the timing of coordinated monetary moves.

Economic policy should be made on the basis of the best available forecast of where the economy is going rather than on the basis of where it has just been. Securing agreements based on forecasts at a given time, however, can be difficult because forecasts can be manipulated or disputed in a way that facts cannot. And policy-makers usually have their hands more than full dealing with the present; they have a rooted aversion to considering anything that might not happen. Nonetheless, a potentially fruitful approach would be to seek conditional agreement for coordinated monetary measures. It would be better to agree now on the correct response if nominal world GNP growth during the remainder of 1986 shows no — or only weak — signs of accelerating, rather than waiting for fears to be confirmed before beginning discussion. Conditional agreement — committing the parties to do something if stipulated events occur and if agreed indicators fall within specified ranges — may be the only way to secure timely coordinated policy responses and to minimize the danger of either recession or inflation

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1. The simulations assumed that monetary policy was set to maintain the same growth of the money stock as would have occurred without the fiscal contraction.

2. There was some diversity among the models, but the disparities were not enormous in this particular case. The standard deviation for the results in the third year was just under four-tenths of a percent. That statistic might be interpreted to mean that while the average estimated effect on GNP in the third year was about 1 percent, there was 60 percent likelihood that the effect would fall in a range between six-tenths of a percent and 1½ percent.

3. Income velocity is defined as the ratio of nominal income (GNP) to the money stock. If the money stock typically grows faster than nominal income, velocity falls.

Illustration by Lise Gladstone

Mr. **Holtham.** I am going to make two sets of remarks, one is on the trade deficit, to which Mr. Olmer has been speaking, and the second set of remarks is on the issue of macroeconomic policy coordination between the United States and its allies.

The point that I would want to stress on the trade deficit is that it is very substantially a macroeconomic phenomenon. One might complain about the trade practices of various countries, but there has been no dramatic change in those trade practices over the last 4 or 5 years, no deterioration which would account, anyway, for the extent of the deterioration in the United States' external position. You have gone from being in balance in 1980 to a deficit of about $150 billion last year. While there may be underlying structural factors that make a contribution, such a large deterioration in such a short time, can only be explained by substantial swings in macroeconomic policy here and abroad.

Therefore, I would argue that the rectification of that position must also depend very substantially on changes in macroeconomic policy here and abroad. While trade negotiations certainly have their importance, particularly in sectoral matters, and, the world being what it is, they play an essential role in a sort of poker game that's going to take place over policy, nonetheless, they are not the main means for putting this situation to rights.

In the last 2 years, there's been a decline of the dollar from a position that was clearly unsustainable. There has been growing concern in the United States that this decline from a peak in early 1985 has not so far made any apparent contribution to reducing the deficit. That fact has lent superficial credibility to arguments that the world has changed, that we are living in a totally different era where past relationships are not holding and where changes in the exchange rate cannot reduce the external deficit.

The Brookings Institution has just completed a study on this issue involving economists from a number of different countries and it does not support that postion. Our findings were as follows. If the U.S. exchange rate were to decline by, say, 20 percent, on the basis of past relationships, the effect in the first year would be to worsen the U.S. trade balance by up to $10 billion at current prices. That is because the depreciation raises the price of imports in dollars but does not increase, may indeed lower the price of exports, and thereby worsens the terms of trade. It takes a long time for businesses to change their source of supply or to gear up to meet new markets so the volume response to those price changes does not come at all quickly. The speed of the turnaround has not always been completely uniform, historically, as there are other specific influences that could influence it. Different economists take different views but there is a broad consensus that it is not at all surprising if it takes 2 to 3 years after a decline of the exchange rate for the benefits to become substantial.

We are in a situation now where the dollar has been depreciating continually in a series of steps for 2 years. So while you are getting the benefit to the external deficit, undoubtedly, from the declines that happened in early 1985, you are still paying the penalty at current prices for the declines that happened in late 1986.

Therefore I do not believe that past relationships are no longer a guide to prediction nor that the decline in the exchange rate is failing to make any contribution to rectifying the present situation. In fact, I would be surprised if the trade deficit didn't improve through 1988 by something of the order of $30 billion at current prices, in consequence of the exchange rate change that we've seen so far.

I don't think that the decline we have had so far would be sufficient to entirely remove the trade deficit. I won't pretend that I can quote hard numbers or very hard numbers, but in terms of rough orders of magnitude, the sort of estimates I've seen would suggest that in 1987 and 1988, there will be an improvement, of about $30 billion; it could get as high as $50 billion perhaps, but that would still leave a substantial deficit in the region of $90 billion or more.

If that isn't removed, then the accumulation of the debt, the continuous accumulation of debt on that $90-plus billion means that the current account, as opposed to the trade account will begin to deteriorate again because of interest payments on that accumulating debt.

So while I think that the decline in the exchange rate is very likely to improve the situation over the next year or two, it is unlikely to be enough and further measures will be needed.

At constant prices the external deficit will improve more, because in calculating it we exclude the adverse price movements following depreciation. Changes in the balance at constant prices have consequences for the growth of the U.S. economy. The estimates made by the OECD for 1986 suggested that the deterioration in the trade balance at constant prices last year cost the United States something like 1 percentage point off its growth rate. Growth was thought to be 2¾ or thereabouts. If the trade balance had not deteriorated, all other things being equal, the U.S. economy would have grown about a percent faster. So merely ending the deterioration of the trade balance at constant prices during 1987 should contribute an increment of that magnitude to the U.S. growth rate compared to 1986. To the extent that there is an improvement in the trade balance that will help still more. An improvement in the deficit of $30 billion in constant (1982) dollars, which is quite likely, would itself add 1 percent to U.S. GNP growth. But a critical qualification to make here is that such an improvement does depend on the level of demand and activity in the rest of the world being maintained. The dollar has fallen and that improves U.S. competitiveness to the point where your trade balance picks up. That equally means that the trade balance of other countries begins to deteriorate and, of course, that is the same sort of drain on their growth that the United States experienced in 1983–86. Many foreign economies are not looking all that vigorous at the moment anyway.

So, in a sense, from the world economy's point of view the swing in external deficits is taking coins out of one pocket and putting them in the other. It is therefore important, I think, that the level of activity in the rest of the world is maintained.

That brings me on to my second set of remarks on international policy coordination. It will not surprise you to hear that, as someone who has spent 10 years in the OECD, I am in favor of international coordination. If I said I wasn't it would be a bit like asking a rat catcher along and then have him tell you that he doesn't know why you want to kill these lovely furry animals. However, international policy coordination should be a continuous process, perhaps a slow process and often a modest process. There is a danger at the moment that, having really rather ignored the possibilities during the early 1980's, the U.S. Government may now expect or try to achieve too much.

To illustrate what I mean by that, there are some numbers in the article that you have before you which show what a very small contribution to the U.S. trade balance there would be from, for example, a temporary fiscal relaxation in Germany and Japan. I think that the point is not that the United States has an interest in getting its allies to boost their economies in order to relieve the U.S. trade deficit. Yet the United States has to persuade its allies that it must get its trade deficit down, that however it does so, whether by reduction of demand in the United States—which nobody here wants because that implies a recession—or whether through a decline of the dollar it must be done. What some foreign governments don't appear to realize is that however it's done, it's done. It means you are taking $150 billion, or some part of it, out of the world economy, out of the demand for goods and services that other countries face, and that means that they simply have to take steps to replace that demand on their own account.

You, in the United States cannot be indifferent to whether other countries do or whether they don't maintain demand because, if they go into recession, in consequence of the United States getting its house in order, that will have quite serious effects in a world which is still saddled by a lot of indebtedness on the part of developing countries. Therefore, if the growth rate falls below some threshold, we shall certainly see a renewed turbulence in financial markets.

So I think the effort on the part of the U.S. Government to persuade the allies that they must maintain the level of demand in their economies is an important one, but I think it should be put in terms of their own interest and not in terms of a contribution they could make to reducing the U.S. deficit. The direct contributions would be a small one but the indirect effects of a failure of demand outside the United States could be large.

I think I will stop there, Mr. Chairman. I would be extremely happy to answer any questions that you might have.

Senator **Sarbanes**. Fine. We thank both of you. We will have 10-minute rounds for questions. Let me start off.

First of all, what, in your view—and I ask this of both of you—are the implications or the ramifications of the United States now having moved from being a creditor to being a debtor nation?

Mr. **Holtham**. The obvious implication for the United States is that in the future, it must make net interest payments to its creditors rather than receiving net payments from its debtors, which means, unless you increase your debt without limit, you have to generate enough income to enjoy the standard of living that you want and still make those transfer payments. One concrete form this might take would be that—if I can use a slightly jargon term—the equilibrium level of the dollar exchange rate might now be somewhat lower, because you now have to have more of a trade surplus or less of a deficit, in order to finance those interest payments.

From the point of view of the world economy, I don't think that the present stock position is all that significant, but it will be significant if the United States goes on adding to its debt for a long time. That then constitutes a call on the savings of the world economy, which, in the long run, presumably is not appropriate.

Mr. **Olmer**. I think it has disastrous potential, Mr. Chairman, not if the United States kept its international debtor status at a relatively low rate, but—as economists are fond of saying in explaining the J curve, things get worse before they get better—I would argue that in the case of the foreign debt payments, when things get worse, they tend to get a lot worse. It has a mushrooming effect, and one of the things that it seems to me not a lot of people bear in mind, is that the net debt status—the net debt account is cumulative. It is not an annualized number.

You look at the international trade balance, that represents a picture at the end of a given year of the current account at the end of a given year, but how much we owe continues to add up. And our interest payments will continue to add up. And the interest payments on the foreign investment in the United States will be added to those payments. We are looking at a situation where, by the end of this decade, or in the early 1990's, we may owe $800 billion abroad, and if we owe that much money, the service on it will conservatively be about $60 billion, and that $60 billion will be reflected in the current account. If we want to post a current account surplus, which we were, at one time lectured on as being the important indication, the well-being of the American economy will face a greater burden on what I argue in my prepared statement is the only area that we can count on, that we have to count on, to see this turnaround. That is the manufactures.

So we are going to have to export more or import a great deal less, in order to begin to bring those accounts into balance. And that is why I think the steadily rising size of the foreign debt payments of the United States has disastrous potential for the economy at large.

Senator **Sarbanes**. It is not quite clear from either of you exactly what policies you see as necessary to address the trade deficit. I take it you both do not regard the underlying structural situation as the root of the problem. Both of you have said it is macroeconomic policies. The only two I have heard mentioned are the valuation of the currency and the necessity for greater coordination and cooperation in economic policies amongst particularly the industrial countries to make sure that we all are expanding in the same direction, not working at cross purposes.

What other policies are we concerned about?

Mr. **Olmer**. I believe that with more open markets and greater opportunities for the sale of U.S. products abroad, we could see our industry make a contribution to reducing the trade deficit.

Senator **Sarbanes**. In what order of magnitude? This is important, because Mr. Holtham makes a point which I have seen elsewhere that despite all of the pressures on the Japanese and the Germans to expand their economies and also become engines of growth, which they ought to do, the impact of that on the American trade deficit would be perhaps $10 billion at best?

Mr. **Holtham**. Just the Japanese and Germans, not other countries; yes. If they were to add, say, 1 percent to their GNP, you would probably get less than $10 billion improvement in the U.S. current account.

Senator **Sarbanes**. And what is the order of magnitude for the figure you are talking about now?

Mr. **Olmer**. If we were to see world markets completely open and fair trade, even as we define it, practiced by everyone, if we were to redo our export control system to keep embargoes on only those products which truly represent strategic technology, if we were to tinker with our trade laws and improve access to dumping and countervailing duty investigations by a larger population of the American economy, if we were to be more aggressive—and this administration in the last year has been extremely aggressive in pursuit of section 301 unfair trade investigation—but if we were to do more of that, I don't think, even then that we would see more than a $12 billion difference.

Senator **Sarbanes**. All right. What else? We're up to only $10 billion or $15 billion now on a trade deficit of $170 billion.

Mr. **Holtham**. Well, Mr. Chairman, it is possible to write a wish list though it doesn't sound like practical politics, when I hear myself say it. First of all, it would be very good if the United States were able to agree with other countries that there should be a further depreciation of the U.S. dollar. As I have said already, I think that what you have had is going to make a substantial contribution in the next year or two. It certainly isn't enough and some more would be indicated. That is not a painless prescription. It does mean a reduction in the standard of living of people in the United States. It means higher inflation in the United States. So it is not something to bandy around lightly, but I think it is something which has made a contribution and could make more.

We also have to face the fact, though, that the balance of risks in the world economy is differently seen here and abroad. The Germans, as we all know, have a rooted fear of inflation, and they are going to make the point—and they are not entirely wrong—that further depreciation of the dollar with no U.S. policy changes would be inflationary for the United States. If, deus ex machina, the exchange rate goes down, there could be eventually an injection of demand into the U.S. economy of over $100 billion, as the trade deficit is reduced. All that demand, instead of going abroad, is falling on the local economy. At that point, with everything else unchanged, you would be moving into an inflationary situation in the United States. The economy is growing at, say, 3 percent. If you would remove the trade deficit and do nothing else, you probably would accelerate growth to an inflationary extent. Our counterpart of the trade deficit has been lower inflation in the United States.

Now I would be very sympathetic to anybody who said, that's some way down the road, but the Germans don't take that attitude. The future inflation danger in the United States is something they are going to point out straightaway.

So I think it would be good if agreement could be reached on the following points: This situation cannot be turned around without some further depreciation of the dollar; it is absolutely critical that while that happens, foreign countries do not allow their economies to slow down in consequence of it; and that as the swing starts to take place, the U.S. Government takes credible steps to rectify the fiscal deficit. In fact, I think there would be much greater possibility of some concrete response from the German and Japanese Governments if they had more faith in the ability of the United States Government to sustain the correction of the fiscal deficit, which has already started. There certainly has been progress on that road, but I am afraid that I don't think that there is great faith in Europe, for example, that that will be sustained. That situation of doubt fuels legitimate fears and militates against other countries taking measures to support demand.

Quite how the package is assembled, I don't know, but I think that the optimal combination would be some further depreciation, some policy stimulus in Japan and Germany, and not necessarily an acceleration of the fiscal correction in the United States but just greater credibility and assurance that it is going to happen.

Senator SARBANES. My time is up.

Let me just ask this one final question. Do you think that Japan, in particular, and West Germany, secondarily, given the size of their economies and the strength of their economies and particularly given the extent to which they have developed such strong economies in recent years, are carrying their share of international economic responsibilities?

Mr. HOLTHAM. Well, I don't think they are following the best policies at present either from their own point of view or, therefore, from the point of view of the world economy. I think they would reject the question in the form you put it, because what we have here is a disagreement about the way the world works rather than any, how can I put it, shortsighted preference of their own interests over global interests. It is not so much that they are saying: "this is what suits us and to hell with the rest of you," as that they have managed to persuade themselves that what they are doing is in everybody's best interest. I don't share their view.

Senator SARBANES. Well, I will come back to this later, but it is hard for me to see how with Japan putting 1 percent of its GNP into defense and the United Stated putting 6 percent, that some adjustments aren't needed, in terms of the economic burden, at least, how the economic burden is internationally shared.

Congressman Wylie.

Representative WYLIE. Thank you very much, Mr. Chairman. I would like to welcome these two distinguished gentlemen, who I know are experts in this field, and we appreciate your comment on this most vital subject now facing our Nation.

I agree with you, Mr. Olmer, that it is a very serious problem, at least, I think most people in the country now feel it is a serious problem, probably second only to the problem of our huge budget deficit.

What is the relationship between our budget deficit and the problems that we have, as far as our trade deficit is concerned, Mr. Olmer?

Mr. **Olmer**. Congressman Wylie, that is a question that Mr. Holtham can better answer I am sure than I. I think that gradually——

Representative **Wylie**. You touched on it a little bit.

Mr. **Olmer**. The budget deficit has kept up real interest rates in the United States for a considerable period of time. It has, therefore, made it easier for us to avoid the honest look at the nature of our economy, that is, that we were consuming a lot more than we were producing and that, therefore, we were funding our excessive consumption by the inflow of foreign capital. I think it kept the value of the dollar up, and I believe that it was essential that the value of the dollar be sustained, in order to attract that foreign capital to the United States.

We waited too long to turn it around.

Representative **Wylie**. I want you to respond to this in a minute, Mr. Holtham. I want to follow up on what you said there about the value of the dollar and the fact that it has been propped up, I guess is the proper way to say it. I was watching the "Today Show" this morning, and they had a gentleman on the "Today Show" from Japan who was talking about the state of Japan's economy, and he was saying that the Japanese economy is in some trouble now, that unemployment is up to 2.8 percent, unheard of in Japan, where they subsidize employment, apparently.

What effect is that likely to have on our trade balance?

Mr. **Olmer**. Well, I would like to think that a Japanese unemployment problem would encourage the Japanese Government to stimulate the domestic economy and put their unemployed back to work. However, any employment that is created as a consequence of domestic stimulation has to be turned toward goods consumed in Japan and not in the direction of its traditional export growth, export led economy. That is at the heart of the report to which I referred, and that is what I believe, as a policy matter, the U.S. Government should work with Japan and encourage it, urge it on Japan, as a matter to be implemented as soon as possible.

If the Japanese Government chooses to inflate, and the economy turns to its traditional way to use that increase in economic activity, it could very well result in a new surge of exports to the United States, and I don't think that that is politically tolerable.

The forecast I have seen suggests the deficit with Japan in 1987 in manufactures will likely be $70 billion. I think that is not sustainable, politically or economically.

Representative **Wylie**. Will that be a plus or minus on our own trade deficit?

Mr. **Olmer**. Well, it is a $70 billion deficit by us in our trade with Japan. We will see marginal improvement in United States exports to Japan and a considerable increase in the value of Japanese exports to the United States.

Representative **Wylie**. Mr. Holtham.

Mr. **Holtham**. Well, there are two issues. One is the question of the Federal deficit. I would go a little bit further than Mr. Olmer. To a substantial extent, the budget deficit was responsible for the excessive consumption, in a broad sense of consumption, in the United States. We know that the administration, in making it, assured everybody that the tax cut would lead, of course, to higher expenditure on the part of the private sector, but would also lead to a tremendous supply side response. Well, no doubt, there was some supply side response, but I think it was always a fantasy to suppose that it was going to be enough to somehow turn a minus into a plus. There was a tremendous expansion in demand in the United States in 1983. Domestic demand grew at 8 percent or something like that, and supply couldn't keep pace, didn't keep pace, and you had the opening up of the external deficit.

As Mr. Olmer has said, one of the ways this worked, one of the channels whereby it worked, was that credit demands in the United States rose. That pushed up interest rates. The exchange rate then rose because of the flow of foreign capital trying to come in and take advantage of those high interest rates and that altered the relative prices of United States and foreign goods. That change in prices induced the consumers, who had extra cash to spend, to spend it on imports.

So I would argue that the deficit, in conjunction with the tight money policy which the Federal Reserve instituted to curb inflation, was very substantially responsible for the increase in the external deficit.

Now there is a problem. If you reduce the budget deficit, certainly, you will cut consumption in the country and make a direct contribution via the lower level of demand to a reduction in the trade deficit. That is a very direct link. But of course, we know that such an action would not leave the level of output unchanged either. Some of the reduced demand would fall on imports but there would also be less demand for goods and services produced in the U.S.A., and that would tend to have a recessionary influence.

I think that is the dilemma which the administration is facing.

Representative WYLIE. I didn't catch that. If we reduced the deficit to the point where it would help our trade balance, that that might have a harmful impact on our own economy? Is that what you said?

Mr. HOLTHAM. Yes.

Representative WYLIE. I heard the word "recession" in there.

Mr. HOLTHAM. The problem here is that everything depends on the route which is followed to reduce the trade deficit. Suppose there is an increase in taxes. Because there is less disposable income then—people have less money; they are paying higher taxes—there will be reduced demand for imports. That will make a direct contribution to reducing the trade deficit, but it is not just for imports that people will reduce their demand. They will also reduce their demand for things produced in the United States, and that will tend to worsen business conditions here.

A reduction in the trade deficit can make a contribution to the shortrun strength of the economy if expenditures that had previously been going abroad are now switched to domestically produced goods. That helps the economy. But if there is just a general reduction in expenditures, that helps the external deficit, but it also weakens the economy in the short run.

The relation between the two deficits is a close one, but they won't necessarily both move in the same direction in all circumstances.

Representative WYLIE. Well, we are looking for answers.

I know Chairman Sarbanes asked some questions along those lines, and apparently the answers are pretty hard to come by as to what we should do to reduce this trade deficit.

Now last year, we passed a trade bill in the House, and I want you to comment on this too, Mr. Olmer, which called, basically, for retaliatory measures by the President. We didn't specifically suggest what the President ought to do, but it said if a country wasn't giving us fair trade practices, that we should retaliate in some way, and I am not sure exactly, as I said, what that meant, but the value of the dollar has declined. How much more should the value of the dollar decline? What should we do? Should we impose import fees? Should we put embargoes on a product-by-product basis? What should we do?

Mr. HOLTHAM. Well, I am not an expert on industrial structure in the United States, so I wouldn't want to say that there is never any case, at the industry level, for particular measures, but viewing import restrictions as a macroeconomic phenomenon, I would be very sorry to see the United States take that road in any serious way. It just is a fact of imports that there must be retaliation to any restriction of imports, and that would cause a slowing in the growth of world trade. And whatever one may think about ups and downs in the world economy, I think it is very clear that much of the growth in prosperity since the Second World War has been owing to the open trading system.

Representative WYLIE. So you would not be in favor of a protectionist measure, which I think is where we are headed in the House?

Mr. HOLTHAM. No, I would not be in favor of protectionist measures. It may well be that you can point, in the case of specific industries, to specific infractions of free trade by other countries, and this makes a case for some specific measure. That is obviously possible, and I am not an expert in that area, but the notion of across-the-board blanket restrictions on imports, I think, is very dangerous. I can see its attractions in the present situation, but I think it is a bit like burning the house down to keep yourself warm. It might appear to provide some relief in a difficult situation but at the cost of undermining a system that has served everybody, the United States and its allies, very well.

Representative WYLIE. Mr. Olmer, please.

Mr. OLMER. Well, I don't shrink from protectionism if properly applied and warranted. I think that the administration has become a lot tougher in the last year and a half, encouraged by the Congress, recognizing the seriousness of the situation and fearful of broader, more restrictive protectionist measures if it didn't do something.

I would point to a current example. The United States and the European Community seem to be marching almost inexorably toward the brink of a trade war, and the difference between the two sides if I am not mistaken—and not being an insider means that I am not really up to speed on current numbers—the difference between the two sides is something like a million tons of corn, and out of that dispute will grow—has grown, retaliation by the President of the United States against a number of European exports to the United States in, so far, only the agricultural area. It will almost certainly lead to counterretaliation by the European Community against the United States, and then we will be obligated to up the ante once more.

Negotiations are going on even as we sit here, and there is hope that the matter will be resolved, as it almost always is, before both sides pitch themselves into the abyss.

I go through that only to say that here are the two largest trading blocs in the world by far and they have been locked into a fearsome dispute that has led to precursors certainly of a broad scale trade war over a few hundred million dollars.

I don't believe the administration is wrong. I believe it is absolutely right. It has the law and it has the equities on its side and it should pursue it. The Europeans tend to argue you can't risk all for a million tons of corn, but the hard reality is the American farmer has been used to a particular market and the Europeans have cut him out of it; we thus need to take strong measures.

And I think that I would by extension apply that to other areas in which U.S. exporters are not being treated equitably. The administration, as I observe it from the outside now, is clearly more willing to do it. I would like to see it perhaps done a little more swiftly, and I believe that, as you point out, Congressman Wylie, Congress is considering a number of measures which will shorten the period in which the administration can make a decision and perhaps scrutinize more carefully what it is the administration is doing and criticize it when it doesn't take action that the Congress believes should be done.

But all in all, it is not going to reduce that $170 billion trade deficit by very much.

Senator SARBANES. Senator Bingaman.

Senator BINGAMAN. Thank you, Mr. Chairman.

Let me just ask each of the witnesses, I have the impression that the trade deficit that has been created over recent years is in a sense a structural deficit, in that there are a series of reasons why it should be very, very difficult for us to reduce—maybe not to reduce it somewhat, but to get it significantly below the $100 billion level for the foreseeable future.

One of these reasons is that U.S. firms have located production overseas. That has contributed, as I understand it, to our trade deficit on a continued basis.

We have lost some of the production of minerals and other types of basic commodities that we used to produce and must now import many of these.

Oil: most of the trends I have seen indicate that we will become more and more dependent upon foreign oil in the next decade, and that will be a growing number in our trade deficit.

Interest on this foreign debt, which was referred to earlier.

I am having great difficulty seeing how this thing is going to be reduced significantly in the near future or even in the foreseeable future, the next decade.

I would be interested in your comments on that.

Mr. OLMER. I think it does, Senator, it has to be done, and I believe that it can come down substantially. I believe that currently the share of our trade deficit which is the consequence of oil import is roughly 25 percent.

You are right, that is likely, most likely, to increase as our dependence on foreign energy increases and as the price of energy increases, but I believe that a lot of U.S. manufacturing which has moved offshore would come back if it had a proper environment that it believed it could count on for an extended period of time.

Much of the movement offshore was occasioned because of a perception that the United States was a relatively hostile environment in which to operate manufacturing and sell into foreign markets. Some of it had to do with a very strong dollar. Some of it had to do with the inability of American manufacturers to sell in foreign markets. The foreign governments or foreign purchasers were not open.

So if the dollar does come down sufficiently to make it possible for manufacturers to remain in the United States and produce competitively with their foreign competition and the U.S. businessman believes that it is going to be that way—and it will look at the kind of macroeconomic policies the Government adopts, and concurrently the administration and the Congress work to do all of these other things—pressure allies into opening up markets, eliminate unnecessary export controls, be more comprehensive about the range of decisions which are taken in a national security sense that have an impact on the economy—do all of these things and create this healthy environment for domestic manufacturing, I am not so sure that we have to accept a $150 billion deficit in the trade account year in and year out.

Mr. HOLTHAM. I think if I had to bet whether the United States would be running a trade deficit or surplus in the 1990's, I would bet it will be runing a trade surplus.

Now, I don't think it will be running necessarily a current account surplus because between now and 1990 you will be piling up a lot of debt and interest must be paid on that debt. So it may be that the current account will remain in the red, but I think it is probable that in the early 1990's you will be running a trade surplus.

The question is not whether it is going to happen so much as how it is going to happen. It can happen in a good way or it can happen in a very bad way. It can happen in a good way if somehow the world manages to avoid a serious recession, foreign growth is held up or picks up, exchange rates adjust perhaps another 20 percent or so, and in the fullness of time the surplus will come about.

The bad way it can happen is that we don't secure policy coordination and the United States is forced into a recession; perhaps because of turbulence in foreign exchange markets, interest rates get driven up, and so the United States gets pushed into a recession. That will certainly help to clear up the trade deficit, too.

The fact is that I came to the United States 18 months ago, when the dollar was at 10 francs 50, I couldn't afford to park my car, never mind buy or rent it. Now, if I go back to Paris, I can't afford to do it there. There is an enormous difference between 10 francs 50 to the dollar and 6 francs 50 to the dollar, which is the change we've seen in the last 18 months.

Now, such shifts in relative prices take time to work, but they do work. On all past experience they work, and because they take such a long time there is always a tendency, I think, to look for deep, irreversible reasons why the world has fundamentally changed. Sometimes the world does change and you have to acknowledge it. But I think there is also a tendency to underestimate the force of such very large relative price movements as the ones we have seen.

Senator BINGAMAN. Let me just ask to follow up on that, if we are to have a surplus in the early 1990's, we are going to have to sell the rest of the world more than we buy from them. What are we going to sell them?

We can't sell them oil because we are going to be buying more of that. We can't sell them agricultural products because in fact they grow and export more agricultural products now than they consume in most parts of the world. We can't sell them manufactured goods because they have the capability of producing manufactured products at least as well as we do.

What are we going to sell them?

Mr. HOLTHAM. Well, they have the capability to produce a wide range of manufactured products, as does the United States, but the question is who can produce them at a comparable level of quality and more cheaply. With the great swing in relative prices we have seen, the United States becomes much more price competitive and it can export goods it wouldn't previously have exported.

If I knew exactly which product lines were going to be winners for the United States, I should be running your industrial policy, but I have no idea.

Senator BINGAMAN. If we have one.

Mr. HOLTHAM. Well, maybe you shouldn't have one if you don't know either. But the historical experience is that such large relative price changes do have an effect, even though we can't necessarily pick the channels in advance.

Mr. OLMER. Senator, in my prepared statement I outline the merchandise trade account. I think you have put your finger on the right issue. If and when the turnaround does come, it will have to come by a major shift in the manufactures trade in the United States, either by a huge increase in our exports or by a huge decrease in our imports of foreign manufactures.

No other source is available from which to make the kind of contribution needed in order to reduce that trade deficit, and my concern is whether our manufacturing sector will be available to do it.

Has too much of it moved offshore? Is too much of it reliant on imports of foreign component products?

I think that is the $64 question.

Has our domestic base in manufacturing shrunk and been eroded and become uncompetitive?

Senator BINGAMAN. Now, am I understanding both of you to say that we are going to have a surplus in trade because we are going to become the highest quality and lowest cost manufacturer in the world sometime in the next 5 years?

Mr. OLMER. No, sir, I didn't mean to say that. I would like to hear Mr. Holtham——

Senator BINGAMAN. Is that what you are saying, Mr. Holtham?

Mr. OLMER. I am saying if it does come it will have to come from the manufacturing sector.

Senator BINGAMAN. I agreed with that.

Mr. **Olmer**. And I question—I have serious questions as to whether it can. I know in a macroeconomic sense, as I tried to point out in my prepared statement, that economists say that it is inevitable. It is inevitable because people will no longer invest in the United States, people will pull their manufacturing out, the U.S. dollar will drop so low that we will become so price competitive that our products will sell far and away better than any foreign products.

Mr. **Holtham**. For example, suppose that the Honda Co. has a contract to supply motor cars to Brazil or China. Where is it going to supply them from? It has opened a lot of factories in the United States. It has its factories in Japan.

Now, the Japanese are not always motivated by shortrun profit considerations, so perhaps I picked a bad example. But clearly where they supply from is going to at least partly be determined by costs, and if costs are lower in the United States then they will supply it from here, so that the existence of multinational enterprises doesn't necessarily mean—far from it—that you don't get corrections in trade flows because of, and in response to, price changes.

And one of the reasons that things do take time is there are American companies who, as you have remarked, have set up assembly plants, even research and development parks in other countries in response to price movements. They will tend to do that less in years to come if those prices have changed.

Because one can't see the precise channels through which things will happen, it is easy to suppose that they won't happen. But if they don't happen, it will be the first time they haven't happened. That is all I can say.

Senator **Bingaman**. Thank you, Mr. Chairman.

Senator **Sarbanes**. As Senator Bingaman is leaving, I want to just intrude in here.

I am struck that neither of you have said much about the importance of resuming growth in the economies of the Third World, in the developing world, as a way of reducing the American trade imbalance.

If you look at the figures that have deteriorated the most over the last 5 years, it is the American trade balance with Latin America. There is just an absolute deterioration in those figures.

Now, the Japanese figures continue to deteriorate, and that is our biggest imbalance with any one country. But if you take our overall balance and what could be done, a resumption of some growth in those countries might very well have fairly quick results for the American trade balance. Neither of you have talked at all about resuming growth in the developing world.

Why don't we save that until it is my time? We will go to Senator Melcher.

Senator **Melcher**. Well, we are going to get into that before I get done with my time. So I am glad you started it, Mr. Chairman.

Senator **Sarbanes**. OK.

Senator **Melcher**. Until Mr. Holtham assured us that we would have a positive merchandise trade balance in the early 1990's, this was a rather discouraging session. I can wait that long.

But you know as we wait for the devalued dollar to show something in the way of correction, we realize that there is a lot of uncertainty about that. Television sets currently now, this month or last month, this month, next month, are selling cheaper than ever, hardly, I assume, because they were manufactured some time ago. Frankly, they can manufacture them cheaper. But we can buy now a stereo television with a better method of—a clearer picture, much better for about the same number of dollars as it cost to buy nice quality a couple of years ago.

So I assume that the J curve is a long curve and the devalued dollar will begin to show us some positive results on the trade imbalances sometime in the future.

We can jawbone all we like here in the United States. The chairman has mentioned a question of mutual defense, with 1 percent of the gross national product—slightly more than 1 percent of gross national product of Japan going into defense efforts or I suspect in the case of our NATO allies it is still running around 3 to 4 percent of gross national product in West Germany or France or Britain as compared to our 6 percent.

Now, we can jawbone on that, but I don't know that anything is going to resolve, or I guess the latest thing we hear now is we should talk about Japan and the European countries stimulating their economy so there is more demand in their own countries and that is going to help us.

Well, that is all jawboning. The pendulum has swung too far here in the United States, this $170 billion trade deficit, and, Mr. Olmer, you tell us even with Japan in 1987 instead of being a reduction there is going to be an increase. You say $70 billion, I believe it was?

Well, I only mention those figures simply to emphasize that the pendulum has swung too far and something is going to give. Congress and the administration will have to act this year, and I believe will act this year on a series of steps under our own control to do something about it. Now I believe the real test is, Mr. Holtham, if your premise is correct, that there will be adjustment. You mentioned, the question is, then, how is it going to be done? Is it going to be done in a good way or a harmful way?

Let me tell you one of the ways it is going to be done, I am confident it will be done, I think we will see some start on it this year of some consequence. Mr. Olmer, you mentioned in your prepared statement, where you have the merchandise trade account in billions of dollars for 1985 and 1986. You show agriculture at a positive $8 billion dropping to a positive of $3 billion for 1986, and I assume that figure for 1986 is accurate. I think it is accurate. I think it is about correct.

Now if we had gone back to 1981, you would have showed a positive of some $40 billion. And so, there has been a very dramatic drop over the past 6 years.

That I believe is one of the good ways, Mr. Holtham, we are going to make some corrections. There is an unmet demand, and I hear every day that I come here that there is plenty of food. We have too much, too much food available, and the Chamber of Commerce yesterday trotted out a figure.

Well, there is an unmet demand, and it is a huge unmet demand. It is a need, and I think we are in a great position here in the United States to alleviate some of that need, and so we will probably be seeing agricultural commodities shipped out of the United States in larger quantities this year through a variety of our programs, which will be part donation and a lot of it long-term credit and, or course, part cash.

Now that combination is available to us. We simply haven't used it as much as we should have. I believe we will start using it now. And when we do that, the Third World countries—and there are about 75 or 80 Third World countries that we have relationships with on agricultural products, through donations, cash sales or long-term credit—I believe will start creating the demand for manufactured goods, getting back to what Mr. Olmer's been talking about. I don't think we can do it any other way. I think it has to start there with the developing countries. The obvious need right now is food. That does create wealth. And under our law, under several of our programs, as a matter of fact, they could convert the donation of food into cash and use the cash for their own uses within their own country with their own currency. And I believe that is the way we get back to stimulating the demand where it can be stimulated and the future demand for manufactured goods.

Any comments?

Mr. OLMER. One of the realities that has developed in the last few years in Latin America has been the development of more competitive industries.

Senator MELCHER. Competitive what?

Mr. OLMER. Competitive industries in manufacturing and the agricultural community. I think that the return to the large surpluses of the 1980–81 period by the United States are going to be very, very difficult to achieve either in agriculture or in manufactures exports to Latin America.

Senator MELCHER. I simply don't want to limit this discussion to Latin America. After all, there are so many people there that are hungry, and there are billions more that live in other parts of the world that are hungry. And I am not talking about being able to pay. Obviously, if they would be able to pay, if they could spare the hard currency to pay us, they might be buying from anywhere. They already would have bought it. The need is there. And it is an unending need. It is a growing need. It is not that we don't have a lot of food that is available for cash, we simply have not much food that has been available either for long-term credit or donation.

Mr. OLMER. Well, I certainly hope that a more aggressive agricultural export program, aided by long-term credit and medium-term credit can restore what had been our pride in America, that is, a highly successful, competitive, export-oriented, agricultural sector that was the envy of the rest of the world and that $40 billion surplus used to be sort of the golden goose. You could afford to take a hit elsewhere, because you counted on your agricultural sector making up for what manufacturers couldn't, and I would like to see it return, sir.

Senator MELCHER. Thank you.

Mr. HOLTHAM. Well, on the issue of world trade in food, I think it just is the case that there has been a great swing in the balance of supply and demand for food in the world in the last decade, partly for a good reason and partly for a bad reason. The good reason is that there are a number of countries, particularly in Asia, now that are self-sufficient or have the potential to be self-sufficient in food, owing to the technological advance. The ones that spring to mind, India and Bangladesh, very large countries of 150 million people on the one hand and several hundred million people on the other.

Senator **Melcher**. How do you base that assumption that India and Bangladesh are self-sufficient in food production?

Mr. **Holtham**. Well, just from the statistics. They have actually been exporting food. It is not so long ago since they were regarded as basket cases. They needed substantial amounts of——

Senator **Melcher**. I am advised that the same condition still exists, that the instances of export are for hard currency for other uses by the Government itself and by the private sector. The private voluntary organizations, such as CARE, which has been in India some 30-odd years, tells me that there has been some improvement, but that there is nowhere adequate supplies of food.

Mr. **Holtham**. Well, then I think there is, clearly, a distribution of income problem within those countries, whereby people with access to the land prefer to sell the food abroad to make more money than they can get by selling it to poor people in the country. I am not going to deny that, but that's essentially, as you can see, a problem of the distribution of income in those countries. Whether they would be exporters, if the distribution of income in those countries was more equal, I am not sure, but what I think is undeniable is that their capacity to produce food over the last 10 to 20 years has greatly increased. Given their existing income distribution, they have gone from being enormous importers to being exporters. That is a pattern which is very general, and there are other countries—Thailand springs to mind, as well, in Asia—who have expanded their food-producing capacity. I think that's on balance a good thing, though they haven't solved the income-distribution problems to which you refer.

The other thing that has happened in the world food market is, in my view, a bad thing; namely, the enormous growth of agricultural production in the EEC. Owing to the Common Agricultural Policy, Europe has made itself virtually self-sufficient in food as well, which, in a sense, doesn't really make sense. They could always have imported it more cheaply from the United States, Argentina, Australia, New Zealand, but essentially for political reasons, they've made themselves self-sufficient. And not only are they self-sufficient, they've dumped surplus on the world market. I think it is very difficult to defend.

So for both of those reasons, there's now quite a radical difference in the balance of supply and demand for food in the world economy, and I don't think that it is really open to the United States to regain its former position in that area.

As to the food aid, I think that is a good thing, obviously, in the case of some countries in Africa, where there is starvation. But it is also dangerous, in that if a country is predominantly agricultural and you flood its market with cheap food, you reduce the income of the local farmers. The farmer might have been the guy who would have bought a tractor made in the U.S.A., or manufactured goods made in other countries. So in a sense, you can't export both food to them and manufactures to them, it just doesn't add up. They themselves have to be generating something from somewhere, in order to buy things from you.

So I think that food aid has a tremendous humanitarian contribution to make to certain countries, particularly in Africa, but it can be dangerous too, and I don't think it is a vehicle for rectifying the U.S. trade position.

On LDC's, more generally, I am well rebuked by Senator Sarbanes. I think he raises an important point, and I should have said something about it.

Some 40 percent or so of U.S. exports goes to the Third World, and their debt problems and their slowness of growth have been a strong contributing factor to the deterioration in the U.S. trade position, and if that could be rectified, it would make a significant contribution to pulling things round. That, in part, was what I meant when I said it was so important for demand and activity in the rest of the world to be maintained. If Germany and Japan go into recession and the United States is pulling a hundred billion dollars out of the world economy by getting its trade in balance, you can imagine what that is going to entail for the exports and the income of LDC's, and therefore, their ability to import.

So I think that is one of the very reasons why the other developed countries have to be pressured to keep up the level of activity in their economy.

Senator **Sarbanes**. Should they not also be pressured, if they are running large current account surpluses, to recycle that capital, so as to provide the possibility of growth for Third World countries?

Mr. **Holtham**. Yes. That is right, but the difficulty there, of course, is that some developing countries are indebted already, and there is a tension which is very familar to all of you. Hence the Bradley-Baker debate asking: is the right way to help developing countries to get them to take on more debt, or is it necessary to think in terms of making the banks take some losses on the loans they have already made.

I agree with your remarks.

Senator **Sarbanes**. I have a proposal that would have the Japanese and Germans essentially fund an international facility that would buy the bank debts at a discount, and then pass that on to the developing countries, pass the discount on.

Mr. **Holtham**. I wouldn't have any comment on the details of that scheme, because I am not familiar enough with it or with its potential difficulties, but I think there is a great case for some imaginative measure along those broad lines.

Senator **Sarbanes**. Let me ask you this question.

Do you regard the measures the administration recently took, Mr. Holtham, on exports from the EEC to the United States as protectionist?

Mr. **Holtham**. Well, yes, though I see them in the context of a general poker game which is going on.

Senator **Sarbanes**. Well, why wouldn't there be an effort to get the other parties not to be protectionist, in the first instance?

I mean, the whole thing was precipitated not by us but by the EEC with respect to what they did to the corn market, wasn't it?

Mr. **Holtham**. Well, I——

Senator **Sarbanes**. When they do that, what should we do, just sit still for it?

Mr. **Holtham**. As I understand it——

Senator **Sarbanes**. I mean, we could sit still for that kind of thing, maybe, when we were running big trade surpluses in a very dominant economic position. Why should we sit still for it now?

Mr. **Holtham**. As I understand the dispute is over the extent of the compensation which is owed to the United States. There is not a dispute over the principle that some compensation is due. The central political problem is that here is this great movement in Europe to get political unification, but when you get right down to it, much of what it consists of is an agricultural cartel. So governments hang on very hard to this, because it is the most concrete expression of European unity there is.

As I have said just now, I think the economic implications of the common agricultural policy are almost totally bad, and I didn't want to defend them, but that is the political background.

Senator **Sarbanes**. Well, I really want to get at the way that the label "protectionist" is used to cover everything whether, in fact, it may constitute a reasonable or unreasonable reaction to an economic situation. Do you think that the United States, in its trade dealings with Japan, is facing unfair trade practices by the Japanese? Do you think our access to their market is on a fully reciprocal basis with their access to our market?

Mr. **Holtham**. I should say not fully reciprocal.

Senator **Sarbanes**. Well, isn't that essentially unfair then? Isn't that contrary to any regime of free and fair trade?

Mr. **Holtham**. Well, obviously, it cannot be described as fully free and fully fair trade. On the other hand, I think the situation has been improving, not deteriorating. You can argue——

Senator **Sarbanes**. Well, that's not good enough anymore. I mean, that's not a bad answer, if we really didn't have these very large economic problems we are talking about, but I don't see that that is an adequate answer in the circumstances in which we find ourselves. Particularly, when you compound it by the fact that the United States provides a security umbrella. We spend 6½ percent of our GNP for defense and Japan is at 1 percent. Some people want to force the Japanese to rearm and become a military power to address that problem. I happen to think that is the wrong way to go. It would seem more sensible for Japan to assume a larger economic role in carrying some of the economic burdens of a strong international trading community.

What would be unreasonable about that?

Mr. **Holtham**. Well, precisely what burdens do you want them to assume?

Senator **Sarbanes**. Well, I think they should make larger contributions to the international financial institutions, in order to address the problems of Third World countries and do it multilaterally and not bilaterally, because if it is done bilaterally, the trade is simply tied into the bilateral arrangement. So you only worsen the trade problems as you move into the future.

What is unreasonable with that?

Mr. Holtham. I don't think that is in the least unreasonable, and I think that will happen, and, indeed, I think it has happened, and one could point out that it sometimes happened a bit too quickly for the comfort of the United States. There have been occasions when other countries have been prepared to increase their World Bank subscription, but to do so would have threatened the veto vote of the United States. There is a tension here too that the more they do that kind of thing, and I am completely in agreement with you that they ought to do it, the more say they get in what goes on, and that has been known to create tensions too.

Senator Sarbanes. Let me ask you, how long do you think you can try to correct trade imbalances by currency devalution? I can see that that is accepted internationally, as long as there is a general perception that the currencies are out of line. But when you reach the point where there is a general perception that the currencies are in line, and that you are then simply gaining an advantage or seeking an advantage through currency devalution, you can't continue to work that particular course, can you?

Mr. Holtham. No, I think the difficulty there is just the period of time it takes for these currency movements to have their effect, and that is the source of that kind of disagreement.

Senator Sarbanes. Now, is it taking longer? Is it taking longer to get around the curve on the letter *J* than it used to and, if so, why?

Mr. Holtham. I don't think it is taking longer, but there was a larger initial imbalance. Moreover to the extent that, in order to correct the trade balance, companies must identify the United States now as the place to source their production, then they have to take that decision, they have to make the investment and establish the plant here. To the extent that there has been the kind of weakening of the industrial structure to which Mr. Olmer has referred and to the extent that that has to be rebuilt, then that will certainly cause everything to take much longer.

The other problem is, of course, that there wasn't a correction of the dollar all at once leaving 2 years subsequently for the effects to work through. The depreciation has been going on almost continuously. So you have not one *J* curve. You have overlapping *J*'s, if I can put it like that, and you have to get around that envelope of *J*'s.

So I think for both of those reasons it is not surprising that things are taking as long as they are.

But people in the United States clearly and understandably want to see evidence that the depreciation is having an effect, and while they don't see that evidence they are inclined to say: let it go further; while people abroad are obviously inclined to, if anything, overestimate the effect the depreciation has had and say, that is enough, now you are getting into unfair competition.

I think the source of that disagreement is an inevitable uncertainty as to what the effect of any given exchange rate will be once it has all come out in the wash, and that is going to be a source of tension for some time.

My personal opinion is that the U.S. dollar could with advantage go somewhat lower still, but I don't minimize the difficulty that one will have persuading the Germans and Japanese of that.

Senator **Sarbanes**. OK. Congressman Wylie, do you have any more questions?

Representative **Wylie**. Looking at the *J* curve, it depends on what the product is and where it comes from, that people expect Scotch to get a whole lot cheaper simply because the dollar is devalued, that it will be just that. There isn't much value in a bottle of Scotch to begin with. It is all in how much taxes it is and how much transportation it is.

But I think, Mr. Holtham, when I asked why do you think India and Bangladesh have an adequate amount of food, you said just looking at the statistics. It reminds me of how misleading statistics can be.

I was at a hearing a year or so ago when people were testifying before the Agriculture Committee on sales of cotton out of China, and when I walked in they were talking about cotton being exported out of China for something like $58 a bale, sold to Japan, Korea, one or the other or both, and I thought, my god, the Chinese have broken through a barrier and they can produce cotton cheaper than anybody else in the world because it costs us somewhere in that range to produce cotton.

So I asked the witnesses is that their cost of production, and indeed it was not their cost of production. The cost of production was around 80 cents—or $80 a bale, 80 cents a pound—I misquoted that. Forget about bales; 80 cents a pound, and our cost is about 55, 58 cents. They were selling it at our cost of production here. The witnesses testified that their cost of production in China was around 80 cents, or 80 to 85 cents.

So why were they selling it cheaper and taking a loss on it? It wasn't because of surplus. There wasn't all that much surplus they had. I suspect they wanted some currency.

The same with looking at statistics of India becoming an exporter of wheat or food. You mentioned Bangladesh. I don't know that they are exporting. If you take the number of people and the number of calories raised, produced in that country, they are lucky if they can hold their own weight on an average.

So you mentioned Thailand. Thailand has been producing a great amount of rice. It now seems to be under stress because of our policies, which have reduced the price significantly in the world. I don't know how good they are.

But I really just mention the food exports from here. I think it will happen, will pick up this year. It will happen because there is a real profound unmet hunger need in probably a billion and a half people around the world, a third of the population, hunger, malnutrition, inadequate nutrition, however we want to phrase it.

I don't want to suggest, however, Mr. Olmer—I thought you made a very good point in mentioning a variety of ways the trade merchandise imbalance will be corrected, and I happen to agree. Just exporting—increasing the amount of food exports will not get us back in 1991 or 1992 or 1993 into a favorable trade balance. It will just help. I think there are many other steps that have to be taken.

I am indebted to you, Mr. Holtham, for reminding us there are ways of doing it that are more favorable to everybody, and hopefully when we take these—what I think will be rather abrupt, arbitrary steps, I hope most of the steps we take here in this country to correct it are fundamentally good ways, as best as they can be anyway. I think it does damage to other people's opportunities and steps on other people's toes. I hope we don't step too hard.

Thank you very much.

Senator **Sarbanes**. Did you want to add something, Mr. Olmer?

Mr. **Olmer**. Yes, two comments.

One, with regard to your observations, Mr. Chairman, about Latin America. I think that I recall correctly that between 1981 and 1983 we lost something in the neighborhood of $18 billion in exports to six Latin American nations, and that figure certainly increased in the course of the next 3 years.

But I do not believe it realistic to anticipate a return to the halcyon days of 1980–81 because in the period of time that has just gone by they have become much more competitive in industrial products, they are refusing to buy what they don't absolutely require, and I am not sanguine about the resolution of the debt crisis.

I do believe that we should increase our exports, both of agricultural products and of manufactured goods, but we are going to have a tougher time doing it.

The other comment I wanted to make goes to the question of how our unfair trade laws deal with nonmarket economies. Our definition of nonmarket economy in the context of our trade laws has been Communist versus non-Communist, and maybe that needs a new look.

I can recall almost as my first act as Under Secretary in 1981 being summoned before Senator Heinz to testify on a pet project of his. That is, a law to deal with the dumping of products by nonmarket economies in the United States. We still don't have an effective law. So maybe we ought to work harder to try to get it. How does the U.S. Government deal with unfairly traded goods from nonmarket economies?

And, second, maybe there should be a new look at the way we define market versus nonmarket economies. I think it would address the question clearly that you raise, sir, regarding textile products, and it might well serve to goose some of the borderline nonmarket economies that are allies. They are not adversaries, but they just look at the world differently than we do.

Senator **Sarbanes**. Mr. Holtham, I have one final point I wanted to put to you because I want to take advantage of your time at OECD and ask you a question.

Some 25 years ago I worked for Walter Heller when he was Chairman of the Council of Economic Advisers here. There was an incredible amount of preparation and concern that went into the U.S. delegation's attendance at OECD meetings. They were regarded then as very important. A careful agenda was developed. There was great emphasis placed on trying to work out a coordinated and concerted position at the OECD meetings.

The United States in fact was often very careful to try to work behind the scene, so it wasn't necessarily out in front in pushing a particular set of policies, but there was a great deal of importance attached to those meetings and a great deal of importance attached to arriving at a common position at OECD.

It is my perception that that has faded in recent years, and that the importance of OECD as a coordinating, policy-setting organization, where you have the major actors together without a preponderance of any one or two has simply faded. I wonder if that is your perception from your experience there?

Do you feel that OECD in effect has been neglected and not used as extensively or as effectively as may once have been the case in trying to coordinate policy?

Mr. HOLTHAM. Well, thank you, Mr. Chairman.

Yes, that is my perception. I think one of the reasons has been a tendency to try and conduct the business of international consultation in smaller and smaller groups, which has led first of all to G-10 and now we have G-5, though with Italian and Canadian pressure getting pushed back up to G-7, and I think that is essentially one reason why the OECD—which is a group of 23, all industrialized countries, and where the smallest committee still includes 10 of those countries—that is one of the reasons why it has fallen, I think, somewhat out of favor with U.S. policymakers.

I also think that these things tend to go in cycles, if I might be allowed a slightly irreverent comment. When a new U.S. administration comes in, it is naturally focused on the United States and what it wants to do there and tends to rather ignore the rest of the world. Then as time goes on, especially if any difficulties develop, it becomes more concerned to put its policies in the context of the rest of the world. So we get much more attention paid to bodies like OECD toward the end of a 4- or 8-year cycle than we do at the beginning.

But I think there has been a decline in the use to which OECD has been put.

There has been a tendency either to move away from coordination—there was a period when people thought that floating exchange rates removed the need for close economic cooperation. I think and hope that that notion has been thoroughly exploded now. But that was for a while acting against organizations like the OECD, and I think the second thing simply is the substitution away from it toward things like G-5.

The point I would make about that is that smaller groups are, indeed, necessary probably when you are coming to the culmination of a process of cooperation and you want to do a deal. Clearly at some point the principals have to get together in a fairly small group. But the only thing I would say is that it is usually easier to do that kind of deal if there has been an ongoing process of consultation at a lower level or the working level, and that is the way in which I think organizations like the OECD in its own area can still play a very useful role. The OECD also has a unique experience and potential for looking at world economic developments in an integrated multilateral way. That is to say it is well placed to assess the impact of our country's policies on other countries and to assess the systemwide effect of shocks like our price increases in large policy changes. This information should be an important input into a process of cooperation.

Senator SARBANES. OK. Thank you, gentleman, very much. We appreciate it.

The committee will stand recessed. Next Thursday at 11:30 a.m. we will have the chairman of the Council of Economic Advisers, Beryl Sprinkel, and his two colleagues before us.

[Whereupon, at 12:05 p.m., the committee recessed, to reconvene at 11:30 a.m., Thursday, January 29, 1987.]

THE 1987 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, JANUARY 29, 1987

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to recess, at 11:45 a.m. in room SD-562, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes, Melcher, Bingaman, and D'Amato; and Representatives Hawkins, Scheuer, Wylie, and Snowe.

Also present: William R. Buechner, professional staff member.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator **Sarbanes**. If the Committee would come to order. Today the Joint Economic Committee resumes its annual hearings in conjunction with the Economic Report of the President for 1987. We are pleased to welcome Beryl Sprinkel, Chairman of the Council of Economic Advisers and his two colleagues on the Council, Thomas Moore and Michael Mussa who will present this year's Economic Report of the President to the Joint Economic Committee.

Gentleman, we thank you for coming up under what we know was a very tight schedule. The Council of Economic Advisers and the Joint Economic Committtee were both established 41 years ago by the Employment Act of 1946. The goal hopefully of both organizations is to improve the understanding and conduct of economic policy and that is what we are here to do today.

I would like just briefly to preface our discussion of economic policy for 1987 with a brief look back over the year just ended.

Real GNP rose at an annual rate of 1.7 percent during the last quarter of 1986, according to the Commerce Department's preliminary figures, which brought total growth for 1986 to 2.5 percent—in line with the 2.7-percent growth rate of 1985.

I might note the budget released in early January characterized this 2.5 percent growth rate as "moderate," whereas the budget submitted a year ago described it as relatively "sluggish," which I think is an interesting change in terminology.

Where inflation is concerned, performance has been more encouraging. The Consumer Price Index rose only 1.1 percent during 1986, the lowest rate since 1961, in large part reflecting a decline in petroleum prices over the past year. Nominal interest rates also declined during the year by about 2 percentage points.

This encouraging downward trend in inflation has not been accompanied by a significant downward trend in unemployment. The unemployment rate of 1986 averaged 7.0 percent, just 0.2 percent lower than in 1985 and only 0.1 percent lower than in 1980.

Of course, we remain confronted with unprecedented deficits, both budget and trade deficits, and with the need to define and carry forward policies that will bring about a reduction in the budget deficit without weakening a sluggish economy, and we need to address the trade balance within an international trading system seriously strained by tension and uncertainty.

It is with these challenges in mind that we turn to the 1987 Economic Report of the President which will be presented to us by the Chairman, Mr. Sprinkel, assisted by his Council members. We welcome you here and we look forward to hearing the statement.

Before you begin, I will defer to my colleagues for any opening statements they might have and, first, I'll turn to the ranking Republican member of the Joint Economic Committee, Congressman Wylie of Ohio.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative WYLIE. Thank you very much, Mr. Chairman. I, too, want to welcome our very distinguished witnesses from the President's Council of Economic Advisers and certainly look forward to your testimony which I know will be very meaningful to the deliberations of this committee.

The economy has been growing steadily since late 1982 and we have now witnessed one of the longest peace time expanses in our history. While it is true that the real gross national product has been growing at only a moderate rate during the past 2 years, this should not cause us to overlook the other major accomplishments from an economic standpoint of this administration.

When President Reagan was inaugurated in 1981 interest rates were very high and inflation had reached such heights that fear was widespread that we might be heading into a hyperinflation area.

We can be thankful that our overall economic policy has brought down inflation and interest rates to levels that no longer cause such fear and worry. On the contrary, we have established a climate in our economic system that will serve as a foundation for future economic growth, in my judgment.

While the President's economic policies deserve substantial credit, I feel that we must also give a large share of the credit to the policies of the Federal Reserve under the Chairmanship of Paul Volcker.

We still have some very demanding tasks ahead of us and we must continue to provide more and more jobs for Americans just as we have during this long economic expansion and we must adjust our fiscal policies to bring down the Federal budget deficit without shocking the economy into a recession.

We need to deal with the trade problem of course, but we must do this in a careful and well-thought-out fashion, and I believe that bringing down the Federal budget deficit could be an important basic first step toward bringing down the trade deficit.

But we want to hear from you. Those are just some views that I have. I appreciate very much your coming here and welcome you. Thank you, Mr. Chairman.

Senator **Sarbanes**. Thank you. Congressman Hawkins.

Representative **Hawkins**. Not at this time, Mr. Chairman. Thank you.

Senator **Sarbanes**. Congresswoman Snowe.

Representative **Snowe**. No, Mr. Chairman. Thank you.

Senator **Sarbanes**. Chairman Sprinkel, if you would proceed, we would be happy to hear from you.

STATEMENT OF HON. BERYL W. SPRINKEL, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY THOMAS G. MOORE, MEMBER; AND MICHAEL L. MUSSA, MEMBER

Mr. **Sprinkel**. Chairman Sarbanes and distinguished members of the committee, it's a pleasure to appear before you today and to present the 1987 Economic Report of the President and the Annual Report of the Council of Economic Advisers.

I will submit my full prepared statement for the record, but I will shorten it for my delivery.

Senator **Sarbanes**. Fine. The full text will be included as submitted.

Mr. **Sprinkel**. Thank you, sir. Mr. Thomas Moore specializes in microeconomic issues, and Mr. Michael Mussa, on my left, specializes in macroeconomics and international finance, and I would like to thank them and all the members of my staff for the hard work that they accomplished over the past several months in preparing this report.

This morning I will first summarize briefly the contents of the report and discuss the administration's economic forecast for 1987 very briefly and also the projections for 1988 through 1992. Then we will be very pleased to answer any questions that you might have about the report.

In preparing this report we have not only focused on the many positive developments which have characterized the current economic expansion, but we have also devoted considerable attention to the important remaining challenges that confront our economy. In addressing these remaining challenges it is critical that we do so with policies that maintain and enhance the significant economic progress that has been achieved over the past 4 years.

The basic theme of this year's report is that the U.S. economy demonstrates continued strength as it moves into the 5th year of the current economic expansion, but that important sectoral and structural problems remain. Over the last 4 years of economic expansion more than 12 million new jobs have been created, inflation has remained at or below 4 percent for many years, interest rates have declined to their lowest levels in 9 years and business investment, which set records as a share of GNP in 1984 and 1985 remained at a high level. In short, the foundation is in place for sustainable real growth in the future with moderate inflation.

The problems that remain, and they are very real in the U.S. economy are primarily sectoral and structural. The Federal Government continues to control too much of the Nation's resources resulting in an excessive deficit. A large trade deficit adversely affects many trade sensitive industries and encourages protectionist sentiment. The domestic oil and gas industry is suffering the consequences of the decline in oil prices. Conditions remain depressed in much of American agriculture and excessive and inappropriate regulations continue to burden businesses and consumers. The report analyzes these problems in detail and assesses policies to resolve them which are conducive to maintaining a sustainable rate of economic growth and to making continued progress in moderating inflation.

Chapter 1 of the report entitled "Growth and Adjustment in the United States Economy," discusses the broad economic issues that have influenced the overall performance of the economy. It reviews the main economic developments of 1986 in the context of the current expansion in comparison with past expansions and in comparison with economic performance in other countries. The relationship between wide swings in inflation, relative product prices and the value of the dollar and current problems in the agricultural, oil, and trade sensitive manufacturing sectors are also examined as is the recent performance of U.S. productivity. Finally, the chapter presents the administration's economic forecast for 1987 and its longer term projections for the 1988 to 1992 period.

Chapter 2, "Budget Control and Tax Reform," begins by examining the importance of and prospects for significant further reductions in the Federal budget deficit by restraining growth of Federal spending while continuing economic growth in the economy. Realization of the long-run benefits of the Tax Reform Act of 1986 is one of the many important reasons for pursuing this approach to deficit reduction. This act by improving overall incentives for economic activity and reducing disparity and tax rates on different forms of economic activity is estimated to increase net national product by approximately 2 percent after the transition problems of some sectors of the economy are resolved.

Chapter 3, "Growth, Competitiveness and the Trade Deficit," argues that the U.S. trade deficit is primarily a macroeconomic phenomenon. It is related to the rapid growth of U.S. domestic demand relative to the slow demand and output growth in the rest of the world. The trade deficit widened as a result of the appreciation of the dollar between 1980 and early 1985. However, the trade deficit has not resulted from weaker productivity and growth in manufacturing which has risen since 1981 at a 3.8 percent annual rate, 46 percent above the postwar average and more than twice the rate prevailing between 1973 and 1981.

The trade deficit also reflects the influence of the large Federal deficit and its impact on the savings investment balance. The chapter argues that the trade deficit will be reduced by stronger internally generated growth in other industrial countries, reduction of the U.S. Federal deficit through spending restraints and policy reforms that encourage growth and restore credit worthiness in developing countries.

Chapter 4, "Opening International Markets," discusses the administration's policy of free and fair trade and avoiding protectionism at home while opening markets to U.S. products abroad. This policy fits well within the broader strategy of reversing the tide of the macroeconomic forces primarily responsible for the deterioration of the U.S. trade balance. The chapter describes the administration's efforts to open international markets and outlines its major initiatives to further these efforts, and in particular the negotiations with Canada over a free trade area and the new round of multilateral trade negotiations will focus on areas of critical interest to the United States: investment; intellectual property rights; trade in services; and agricultural products.

Chapter 5, "Toward Agricultural Policy Reform," discusses the current state of U.S. agricultural policy and proposals for its reform. The chapter argues that existing agricultural policies have resulted in enormous budgetary costs, benefits that do not reach those most in need, wasteful surpluses of farm products and higher costs to consumers. The proposed solution is to reform agricultural programs by gradually decoupling farm income support from farm production and linking it to financial need.

Chapter 6, "Risk and Responsibility," discusses examples of excessive and inappropriate Federal regulations that unduly limit individual choice, raise costs, and discourage economic activity. In some cases regulations even worked against their intended purpose. Rigid rules, such as some designed to reduce workplace hazards, can reduce employment and production without a coresponding gain in occupational safety. In this and other areas where Government intervention may be indicated, the costs of regulations should be weighed against their likely benefits. The chapter concludes that reliance on personal responsibility and market incentives with an appropriate limited role for Government provides the best method for reducing risk.

The final chapter of the report, "Women in the Labor Force," examines one of the most important structural changes in the U.S. economy, the increasing participation of women in the labor force. Over the past decade, women have accounted for 62 percent of total labor force growth. The increasing labor force participation of women has not led to increases in unemployment rates for either men or women and has made an important contribution to growth of real per capita income while providing women choices and opportunity.

Because many women now plan longer careers and acquire the requisite education, experience, and skills, wages of women both absolutely and relative to those of men have been rising in the 1980's. These developments testify to the flexibility of U.S. labor markets and to the capacity of the market oriented U.S. economy to generate productive and rewarding jobs for an expanding labor force.

Let me turn now briefly to performance in 1986. While real economic growth was moderate and perhaps modest in 1986, real GNP increased by 2.2 percent, fourth quarter to fourth quarter, and 2.5 percent year over year. That growth occurred in an environment of modest inflation, declining interest rates, and continued healthy employment growth. The inflation rate in 1986 benefited greatly from the decline in oil prices early in the year. The CPI in 1986 rose only 1.1 percent, the lowest rate in 25 years. Even if the effects of oil prices are removed, however, inflation remained in the

3 to 4 percent range, the 5th consecutive year it has been at or below 4 percent.

My prepared statement continues for several pages describing some of the detail. I will skip that and go to where I will talk briefly about the outlook for 1987 and beyond.

The administration forecasts a strengthening of economic growth with continued moderate inflation in 1987. Real GNP is predicted to increase 3.2 percent from the fourth quarter of 1986 to the fourth quarter of 1987. Expectations of stronger real growth in 1987 are related to three important factors. First, the adjustment in the gas and oil industry to lower oil prices is largely complete and conditions in that industry are not expected to deteriorate further. Second, the trade deficit is expected to improve in 1987 in response to the substantial depreciation of the dollar and resultant improved competitiveness of U.S. exports. Third, the short-term adverse effects of tax reform should end in 1987. This has apparently contributed to the decline in business fixed investment in 1986.

The unemployment rate is forecast to decline slightly to 6.5 percent in the fourth quarter of 1987 and to continue its gradual decline to 5.5 percent in 1992. Inflation is projected to return to the 3.5 to 4 percent range in 1987 as the effect of falling oil prices recedes and the lower dollar translates into higher import prices. After this temporary increase in 1987 the inflation rate is expected to decline gradually to 2.2 percent by 1991.

I would like to emphasize that the administration's forecast and longer term projections are conditional on critical assumptions concerning economic policy. First, it is assumed that the Federal Reserve will continue a policy that is both consistent with gradual achievement of the long-term growth of price stability and not so restrictive as to impair economic growth. Second, our economic forecast and projections assuming that continued progress is made in reducing the Federal budget deficit in accord with the Gramm-Rudman-Hollings targets, primarily through spending restraint and economic growth.

Deficit reduction through spending restraint is imperative for a number of reasons. In addition to placing an unfair burden on future generations, deficits need to be reduced in order to preserve the long-run benefits of tax reform. Lower marginal tax rates provided by tax reform will encourage productivity and economic growth, but businesses and individuals must perceive tax changes to be permanent and to adjust their behavior accordingly. Thus, the continuous threat of future tax increases is a deterrent to realizing the long-run economic benefits of tax reform.

In conclusion, we believe that many of the sectoral problems and structural adjustments that have adversely affected the aggregate economy are largely behind us and will not be important restraints on growth in 1987. The adverse effects in the oil and gas industry of the oil price declines are abating and many of the benefits to other industries are yet to be fully realized. The dollar has adjusted substantially and U.S. exports are becoming more competitive in foreign markets. As a result, the trade deficit is expected to improve and be a positive contributor to growth in 1987. However, we must make continued progress in reducing the budget deficit through spending restraint so as to insure further substantial improvements in the trade deficit in coming years.

The fundamental signs are positive for 1987, inventories are low, interest rates have dropped and inflation remains subdued. Monetary policy has been accommodative and leading indicators are strong. Thus, the indicators that have historically signaled an end to economic expansion are not present. We have made substantial economic progress in the past 4 years and if we can succeed in reducing the budget deficit by restraining the growth of Government spending, our goal of achieving sustainable real growth and expanding job opportunities and long-run price stability is within our grasp. Thank you, sir.

[The prepared statement of Mr. Sprinkel follows:]

PREPARED STATEMENT OF HON. BERYL W. SPRINKEL

Chairman Sarbanes and distinguished Members of the Committee, it is a pleasure to appear before you today to present the 1987 Economic Report of the President and the Annual Report of the Council of Economic Advisers. Accompanying me today is Thomas G. Moore, Member of the Council of Economic Advisers, who specializes in microeconomic issues, and Michael L. Mussa, Member of the Council of Economic Advisers, who specializes in macroeconomics and international finance. I would like to take this opportunity to thank my staff, who worked long hours over the last several months on this Report.

This morning, I will first summarize briefly the content of the Report and discuss the Administration's economic forecast for 1987 and projections for the years 1988 through 1992. Then, Dr. Moore, Dr. Mussa, and I will be happy to answer your questions about the Report or other economic issues of interest to the Committee.

In preparing the Report, we have not only focused on the many positive developments which have characterized the current economic expansion, but have also devoted considerable attention to the important remaining challenges that confront the economy. In addressing these remaining challenges, it is critical that we do so with policies that maintain and enhance the significant economic progress that has been achieved over the past four years.

The basic theme of this year's Report is that the U.S. economy demonstrates continued strength as it moves into the fifth year of the current economic expansion, but that important sectoral and structural problems remain. Over the last 4 years of economic expansion, more than 12 million new jobs have been created, inflation has remained near or below 4 percent, interest rates have declined to their lowest levels in 9 years, and business investment, which set records as a share of GNP in 1984 and 1985, remains at a high level. In short, the foundation is in place for sustainable real growth with moderate inflation.

The problems that remain in the U.S. economy are primarily sectoral and structural. The Federal government continues to control too much of the Nation's resources; a large trade deficit adversely affects many trade-sensitive industries and encourages protectionist sentiment; the domestic oil and gas industry is suffering the consequences of the decline in oil prices; conditions remained depressed in much of American agriculture; and excessive and inappropriate regulation continues to burden businesses and consumers. The Report analyzes these problems in detail and assesses policies to resolve them which are conducive to maintaining a sustainable rate of economic growth and to making continued progress in moderating inflation.

The Report of the Council of Economic Advisers

Chapter 1 of the Report, entitled "Growth and Adjustment in the United States Economy," discusses the broad economic issues that have influenced the overall performance of the economy. It reviews the main economic developments of 1986 in the context of the current expansion, in comparison with past expansions, and in comparison with economic performance in other countries. The relationship between wide swings in inflation, relative product prices, and the value of the dollar and current problems in the agricultural, oil, and trade-sensitive manufacturing sectors are also examined, as is the recent performance of U.S. productivity. Finally, the chapter presents the Administration's economic forecast for 1987 and its longer term projections for the 1988-1992 period.

Chapter 2, "Budget Control and Tax Reform," begins by examining the importance of, and prospects for, significant further reductions in the Federal budget deficit by restraining the growth of Federal spending. Realization of the long-run benefits of the Tax Reform Act of 1986 is one of the many important reasons for pursuing this approach to deficit reduction. This Act, by improving overall incentives for economic activity and reducing disparities in tax rates on different forms of economic activity, is estimated to increase net national product by approximately 2 percent, after the transition problems of some sectors of the economy are resolved.

Chapter 3, "Growth, Competitiveness and the Trade Deficit," argues that the U.S. trade deficit is primarily a macroeconomic phenomenon. It is related to the rapid growth of U.S. domestic demand relative to the slow demand and output growth in the rest of the world. The trade deficit widened as a result of the appreciation of the dollar between 1980 and early 1985. However, the trade deficit has not resulted from weaker productivity growth in U.S. manufacturing, which has risen since 1981 at a 3.8 percent annual rate, 46 percent above the post-war average, and more than twice the rate prevailing between 1973-81. The trade deficit also reflects the influence of the large Federal deficit and its impact on the savings/investment balance. The chapter argues that the trade deficit will be reduced by stronger internally generated growth in other industrial countries, reduction of the U.S. Federal deficit through spending restraint, and policy reforms that encourage growth and restore creditworthiness in developing countries.

Chapter 4, "Opening International Markets," discusses the Administration's policy of free and fair trade -- avoiding protectionism at home while opening markets to U.S. products abroad. This policy fits well within the broader strategy of reversing the tide of macroeconomic forces primarily responsible for the deterioration of the U.S. trade balance. The chapter describes the Administration's efforts to open international markets and outlines its major initiatives to further these efforts. In particular, the negotiations with Canada over a free trade area and the new round of multilateral trade negotiations will focus on areas of critical interest to the United States: investment, intellectual property rights, trade in services and agricultural products.

Chapter 5, "Toward Agricultural Policy Reform," discusses the current state of U.S. agricultural policy and proposals for its reform. The chapter argues that existing agricultural policies have resulted in enormous budgetary costs, benefits that do not reach those most in need, wasteful surpluses of farm products, and higher costs to consumers. The proposed solution is to reform agricultural programs by gradually decoupling farm income support from farm production and linking it to financial need.

Chapter 6, "Risk and Responsibility," discusses examples of excessive and inappropriate Federal regulations that unduly limit individual choice, raise costs, and discourage economic activity. In some cases, regulations even work against their intended purposes. Rigid rules, such as some designed to reduce workplace hazards, can reduce production and employment opportunities without a corresponding gain in occupational safety. In this and other areas where government intervention may be indicated, the costs of regulations should be weighed against their likely benefits. The chapter concludes that reliance on personal responsibility and market incentives, with an appropriate, limited role for government, provides the best method for reducing risk.

The final chapter of the Report, "Women in the Labor Force," examines one of the most important structural changes in the U.S.

economy -- increasing participation of women in the labor force. Over the past decade, women have accounted for 62 percent of total labor force growth. Increasing labor force participation of women has not led to increases in unemployment rates for either men or women, and has made an important contribution to growth of real per capita income. Because many women now plan longer careers and acquire the requisite education, experience, and skills, wages of women, both absolutely and relative to those of men, have been rising in the 1980s. These developments testify to the flexiblity of U.S. labor markets and to the capacity of the market-oriented U.S. economy to generate productive and rewarding jobs for an expanding labor force.

Economic Performance in 1986

While real economic growth was moderate in 1986 -- real GNP increased by 2.2 percent from fourth quarter to fourth quarter -- that growth occurred in an environment of modest inflation, declining interest rates and continued healthy employment growth. The inflation rate in 1986 benefited greatly from the decline in oil prices early in the year. The CPI in 1986 rose only 1.1 percent, the lowest rate in 25 years. Even if the effects of oil prices are removed, however, inflation remained in the 3 to 4 percent range -- the fifth consecutive year it has been near or below 4 percent.

The goods news on the inflation front has translated into another extremely important development this past year, dramatic declines in interest rates. Interest rates in December were 150-200 basis points below levels of a year ago and 700-800 basis points below their cyclical peaks in 1982. To a large extent, this is a reflection of the downward adjustment of inflation expectations that has been occuring gradually since 1981 and proceeded through 1986. A recent survey of financial market experts indicates that in December expectations for inflation over the next ten years fell below 5 percent for the first time since the survey's inception in 1978. In combination with current levels of nominal rates, this implies a real long-term interest rate of about 2 to 2-1/4 percent, which is generally consistent with the level of real rates experienced in the late 1950s and 1960s. Most important, this is a substantial improvement over the very high real rates observed early in this expansion.

Continued moderate inflation and the declines in interest rates in 1986 are particularly significant achievements when viewed in the context of previous postwar expansions. January is the 50th month of this economic expansion, which is exceeded in length by only two other expansions in the postwar period, the 1975-80 expansion and the 1961-69 expansion, the length of which was likely extended by the buildup of the Vietnam War. A marked difference between this expansion and its predecessors is that there is currently no sign of a reacceleration of inflation, and interest rates continue to decline. In stark contrast, by this point in previous postwar expansions, both inflation and interest rates had turned up, frequently signalling an imminent downturn in the economy. Viewed over the entire postwar period, each cyclical upturn has taken inflation and interest rates to new highs, and in economic downturns inflation and interest rates have generally remained above their previous lows. This sequence of progressively higher inflation and interest rates has been broken in this expansion. With this achievement, the foundation for sustainable real economic growth without a renewal of inflation has been strengthened.

In the context of moderate real growth and low inflation in 1986, the U.S. economy has continued to generate healthy employment growth. At 6.6 percent in December, the total unemployment rate remains high by postwar standards, but 2-1/2 million additional people have been put to work in the past year. In 1986, the share of the population over 16 years of age that is employed hit an all-time high. This contrasts sharply with the experience of other industrial nations. In each year of this expansion, the U.S. economy has generated more jobs than the combined economies of Canada, France, Italy, Japan, United Kingdom, and West Germany.

All this good news does not belie the fact that some sectors of our economy are experiencing serious difficulties. The oil price declines in early 1986 quickly and severely affected the domestic oil and gas industry. Real investment in that industry fell over $10 billion and more than 150,000 jobs were lost in the first half of the year. Many trade-sensitive industries continue to suffer, as U.S. exports have not risen as rapidly as was predicted from the depreciation of the dollar since early 1985. The agricultural sector continues to be depressed. In addition, in many regions heavily dependent on these industries, the difficulties have spread to support and service industries as well.

While the distress in these regions and industries is real and cannot be discounted, it is also important to recognize that these problems are largely sectoral and limited to specific regions of the country. Moreover, as is discussed in Chapter 1 of the Report, economic progress has been widespread among industries and regions of the country, despite problems in some areas. Employment gains, for example, have been registered in the past year in 39 states and the District of Columbia. Thus, the assertion that economic growth is centered on the two coasts of the United States with stagnation across the middle section of the country is an exaggeration.

The Outlook for 1987 and Beyond

The Administration forecasts a strengthening of economic growth with continued moderate inflation in 1987. Real GNP is predicted to increase 3.2 percent from the fourth quarter of 1986 to the fourth quarter of 1987. Expectations of stronger real growth in 1987 are related to three important factors. First, the adjustment in the gas and oil industry to lower oil prices is largely complete and conditions in that industry are not expected to deteriorate further. Second, the trade deficit is expected to improve in 1987, in response to the substantial depreciation of the dollar and resultant improved competitiveness of U.S. exports. Third, the short-term adverse effects of tax reform should end in 1987. This has apparently contributed to the decline in business fixed investment in 1986.

Real investment in 1987 is expected to strengthen because of gains in nonresidential fixed investment and inventory investment and despite a slowdown of growth in residential investment (which was very strong in 1986). As the adverse effects on investment of the oil price declines and the short-run effect of tax reform wear off, the benefits of lower interest rates, rising corporate profits, and stronger economic growth should provide a boost to capital investment.

Although consumer spending is not expected to grow at the pace witnessed in 1986, it is still expected to make a substantial contribution in 1987, buoyed by a rapid increase and high level of consumer net worth. Consumers may, however, hold growth of consumption spending below growth in disposable personal income in order to restore current low personal savings rates to more normal levels.

After holding down real economic growth in 1986, real net exports are expected to contribute positively to growth in 1987. The falling dollar appears finally to be influencing the prices of non-oil imports. The fixed weighted price index for non-oil imports rose 9.4 percent during 1986 and further increases are expected in 1987. Higher relative prices for goods imported into the U.S. and lower relative prices of U.S. exports in foreign markets should improve U.S. net exports.

Continued modest growth of real spending by State and local governments seems likely in 1987, given their relatively strong budget positions. In contrast, the program to reduce the Federal fiscal deficit should lead to a modest reduction in real Federal purchases of goods and services in 1987. The restraint of spending growth implied to achieve the Gramm-Rudman-Hollings targets is not expected to be an important negative factor in 1987, however. As the growth of government spending is controlled, resources are free to move to the private sector.

The unemployment rate is forecast to decline slightly to 6.5 percent in the fourth quarter of 1987, and to continue its gradual decline to 5.5 percent in 1992. Inflation is projected to return to the 3-1/2 to 4 percent range in 1987 as the effect of falling oil prices recedes and the lower dollar translates into higher import prices. After this temporary increase in 1987, the inflation rate is expected to decline gradually to 2.2 percent in 1991.

I would like to emphasize that the Administration's forecast and longer term projections are conditional on critical assumptions concerning economic policy. First, it is assumed that the Federal Reserve will continue a policy that is both consistent with gradual achievement of the long-term goal of price stability and not so restrictive as to impair economic growth. Second, our economic forecast and projections assume that continued progress is made in reducing the Federal budget deficit in accord with the Gramm-Rudman-Hollings targets, primarily through spending restraint and economic growth. Deficit reduction through spending restraint is imperative for a number of reasons. In addition to placing an unfair burden on future generations, deficits need to be reduced in order to preserve the long-run benefits of tax reform. Lower marginal tax rates provided by tax reform will encourage productivity and economic growth. But businesses and individuals must perceive tax changes to be permanent to adjust their behavior accordingly. Thus the continuous threat of future tax increases is a deterrent to realizing the long-run economic benefits of tax reform.

In conclusion, we believe that the sectoral problems and structural adjustments that have adversely affected the aggregate economy are largely behind us and will not be important restraints on growth in 1987. The adverse effects in the oil and gas industry of the oil price declines are abating, and many of the benefits to other industries are yet to be fully realized. The dollar has adjusted substantially and U.S. exports are becoming more competitive in foreign markets. As a result, the trade deficit is expected to improve and be a positive contributor to growth in 1987. However, we must make continued progress in reducing the budget deficit through spending restraint so as to insure further substantial improvements in the trade deficit in coming years.

The fundamental signs are positive for 1987: inventories are low, interest rates have dropped, inflation remains subdued and monetary policy has been accommodative. Thus, the indicators that have historically signalled an end to economic expansion are not present. We have made substantial economic progress in the past four years and, if we can succeed in reducing the budget deficit by restraining the growth of government spending, our goal of achieving sustainable real growth, expanding job opportunities and long-run price stability is within our grasp.

Senator **Sarbanes**. I will say to the members of the committee I think we will follow a generous 5-minute rule. Then we can have subsequent rounds of questions. That might work better for members' time schedules.

Mr. Sprinkel, I want to focus on the forecasting question for just a moment. In the budget last year the administration predicted that the economy would grow 3.4 percent in 1986. Instead it grew, on the basis of the preliminary fourth quarter figures, 2.5 percent. Where did the forecast go wrong last year?

Mr. **Sprinkel**. There were essentially two areas that were not properly anticipated. One was the very sharp decline in oil prices which were underway when the report was being written, but certainly no one even at that point in time believed that the drop would be as sharp and as persistent as it turned out to be.

That led to a substantial overestimate on the investment side, and most of it directly related to the very prompt cutback in costs in the oil and gas industry and the layoff of a few hundred thousand people.

A second major factor that led to an overestimate, in my opinion, was the expectation, and I think widely held but unrealized, that we would begin to see in the latter half of the year some clear evidence of improvement in our trade deficit.

And the best you can say even up until today, in my opinion, is that it ceased getting worse. We think it is on the verge of improvement. There was a slight seven plus billion improvement in exports in the fourth quarter in the first preliminary estimate of GNP, but we haven't really started a significant improvement in that area yet. We think it will happen. Those were the two major ones.

Now as a result of somewhat slower growth and anticipated inventories, they did not rise as they would have "ex" the depressants I just mentioned.

Senator **Sarbanes**. Let me pursue that a little further. In the past August the Council issued a statement predicting that real growth would accelerate to 4 percent in the second half of 1986. At that point you were already into the period for which you were making the forecast.

At the time the average growth rate reported for the first half of the year was 2.4 percent, and we now see that the growth rate for the second half was 2.3 percent.

Why was your estimate that the economy would rebound that strongly in the latter half of the past year so far off the mark? It is even further off the mark than the prediction at the beginning of the year.

Mr. **Sprinkel**. Primarily because we persisted in believing that the trade deficit would change in the last half. It had been essentially removing 1 full percentage point from economic growth. If it ceased getting worse and just held still, that would have added 1 percent to growth, and if it began it get a little better, it would have been more so.

But as I indicated, there has not yet been clear evidence that it's turned. I persist in believing that it's in the process, but at least on preliminary numbers we can't prove it for certain.

Senator **Sarbanes**. Let me pursue this further. The administration is projecting that real GNP in 1987 will be 3.1 percent higher than in 1986. We have heard testimony from some of the private forecasters and looked at the consensus among the private forecasters, which is at a figure of 2.4 percent. What explains your more optimistic forecast? Where do you differ from the private forecasters?

Mr. **Sprinkel**. There is a broad array. I know of many that are well above our estimates, but you are correct that the average of the group is somewhat below ours. They all have different approaches, but I think that one of the differences is that we anticipate a significant swing on the trade accounts on the order of $30 billion annual rate fourth quarter to fourth quarter plus or minus a little bit. Some are more optimistic. I see some saying 40, but there are some less optimistic than 30.

We do not project as sharp a rise in consumer spending this coming year. We think that consumer spending will rise more slowly than income, but some have it rising even less than we have projected, and I think that is part of the difference.

It's also our view that the oil and gas cutback in investment is mostly behind us and especially in the last half of the year. We anticipate positive performance on capital spending due to several factors, one, the sharply lower interest rates, a significant improvement in corporate profits reflecting not only improved economic growth but also good cost control.

So I think in those general areas I've seen no one predict a sharp increase in Government spending or even a sharp contraction. Most of the projections show a modest contraction in real Government spending. So I don't think there is much difference in that area. There may be some difference in inventory swings also.

Senator **Sarbanes**. Expectations about the trade deficit seem to run through your response in each of these predictions, which really miss the mark by a substantial degree.

In your expectations now on the trade deficit, are you assuming that the dollar will go lower than it now is?

Mr. **Sprinkel**. We have made no assumptions about the future course of the dollar and, fortunately, for this purpose it isn't necessary to do so. The reason it isn't necessary to do so is that a change in an exchange rate does not have an instantaneous or even a very prompt effect on trade, either exports or imports. It's out there a year and a half or even a little longer before any significant impact occurs.

Consequently, we can look at what has happened to the dollar up to now, which is what we did do when we wrote the report, and make the projections on those bases.

Senator **Sarbanes**. How long does it take to work around the "J" curve before it starts reflecting itself?

Mr. **Sprinkel**. If I may, I would like to turn that question over to my colleague, Mr. Mussa, who is a real expert. I had said something on the order of a year and a half, but he has done a lot of work in this area and, if I may, I would like to for him to elaborate on that answer.

Mr. **Mussa**. Most of the estimates do show a year and a half to 2 years for the major effect to be felt, and some show that there will be initial deterioration rather than improvement, which is the "J" curve effect, the down leg of the "J" curve.

I think virtually all analysts have been surprised at the slowness with which the adjustment to the lower dollar has occurred over the last nearly 2 years since the dollar began depreciating in early 1985.

Part of the reason for that appears to be that the relative prices of internationally traded goods, particularly imports into the United States, did not begin to turn up in response to depreciation of the dollar until 1986. Imports overall in 1986 fell in relative price due to the effect of the oil price decline, but if you exclude oil, then in 1986 nonoil import prices rose by a little bit over 9 percent.

It takes a while even after those switches in relative import prices for the effect to be fully felt on quantities, and we just seem to be getting longer delays than has normally characterized the response to large exchange rate movements in the past. I think the consensus view still is that the effect is coming but it hasn't yet arrived.

Senator **Sarbanes**. My time is up and I will pursue this on my second round. I would just close by noting that last year the Council testified that the decline of the dollar would cause the trade deficit to bottom out during 1986. Instead the deficit rose from $148 billion in 1985 to about $175 billion in 1986, but I'll come back to this on the second round. Congressman Wylie.

Representative **Wylie**. Thank you, Mr. Chairman. I want to pursue the matter of the trade deficit, too, though and follow up on your question because trade legislation has been given a high priority by the Speaker of the House and he has had some meetings trying to develop a bipartisan trade bill policy.

You say in your prepared statement "As a result the trade deficit is expected to improve and be a positive contributor to growth in 1987." Then you have a caveat though, "However, we must continue progress in reducing the budget deficit."

I happen to think that the Federal budget deficit is a very important basic factor in reducing our trade deficit. How important to the trade deficit do you think reducing the budget deficit is?

Mr. **Sprinkel**. I think it is one of the most important improvements that we can make that will contribute to it. We, fortunately, are in a position where the fiscal deficit this year has come down significantly as a result of the action of the President and the Congress, maybe a $40 or $50 billion decrease.

If we can succeed in convincing the Congress to take most of the elements of the President's new budget, we will make further progress 2 years in a row of reducing the fiscal deficit from 5 percent plus of GNP down to something not very nearly so serious of less than 3.

I think understanding that relationship is a very difficult one. There is no simplistic relation between the fiscal deficit per se and the trade deficit. If you try to draw a correlation you won't find much. But the best way that I find of thinking about it is to recognize that the United States in recent years has been spending more than it produced. This means that we have been importing more than we are exporting.

Now when you spend more than you produce, you have to finance it. It's quite analogous to an individual. If an individual spends more than his income, he has got to do one of two things. He has either got to borrow or he has got to liquidate assets.

The same thing happens for the United States. We must borrow abroad or we just liquidate assets that are in the United States, and both of those trends are developing.

Now this import of capital from abroad reflects the overall saving deficit in the United States. That includes the private relations, that is private savings that are generated by individuals and by business and investment by the business community, whatever that balance is plus the deficits of the Federal Government and of the surpluses of State and local governments.

So that it's a combination of these forces of which the Federal deficit is a very important factor because it's continuing large into the 5th year of an economic expansion that makes it a critical variable in reducing further in the future our very sizable and painful trade deficit.

Representative WYLIE. Thank you. I want to pursue this question which the Chairman propounded a little earlier, the observation that if the dollar was allowed to fall in the international market that it would result in a favorable trade deficit.

The fact of the matter is that our deficit did increase to $170 billion this year, and then there has been some talk about maybe the dollar has fallen too much already and that we should try to make some effort to support it now.

Do you have a concern that maybe the dollar has fallen, a concern about the possibility of a free fall? Has the fall gone far enough and what are the implications of it falling further?

Mr. SPRINKEL. Well, it's very difficult for anyone to decide what the proper rate should be. We have only two individuals in our Government authorized to talk about that issue, and that is the President of the United States and the Secretary of the Treasury, and I'm neither.

The reason it's very complicated is that it depends on not only what happens here with our economic growth, with our fiscal deficit, but what happens abroad in terms of their economic growth and in terms of their willingness to open markets to our exporters.

Consequently, it is one of the important adjustment mechanisms, but it is not the only one. In fact, I would argue that under most circumstances it is not even the favored one because it is costly.

When exchange rates move significantly over a long period of time it causes chaos in our exporting industries if the dollar is moving up and given sufficient lags later. It means people lose jobs, at least in the short run. They have to move into different industries. Capital has to back out and move into other industries.

The opposite thing is happening abroad, and now as we unwind we will reverse that trend. So we would like to place more emphasis, as Secretary Baker has indicated on many occasions, on achieving better economic coordination of basic macropolicies which will not eliminate but at least reduce the extent to which exchange rates must move.

Representative WYLIE. My time is up, but I want to ask one more question before I leave you here right now.

Many of us know from personal experience that the stock market isn't a perfect leading indicator. Nonetheless, what might the current stock market boom be saying about the economic outlook? I asked that question of some economists here last week. So it's a followup.

Mr. Sprinkel. Well, I used to spend a lot of time worrying about that when I was in the private sector. I spend less here. But I do think that the strong market in general, and I'm not talking about any one day or any week because I have no idea, does reflect the fact that expectations about the trend in the economy are favorable. It's well understood that as activity picks up, especially in the manufacturing area, and that's beginning, that they have done a good job of getting their costs under control and this leads to expectation of substantial, profit improvement.

It also reflects the fact, in my opinion, that we have had an expansionary monetary policy with considerable growth in monetary aggregates, if you want to measure it that way or the declining interest if you want to measure it a different way, and I think it is a combination of these forces.

It's true that the stock market sometimes goes down in periods that are not followed by recessions, but I don't know of any recession that got underway with the stock market going up. So I consider it a comforting sign that we still have strengths in financial markets.

Representative **Wylie.** Thank you, Chairman Sprinkel. Thank you, Chairman Sarbanes.

Senator **Sarbanes.** Congressman Scheuer.

Representative **Scheuer.** How about 1929, wasn't that a time when we were gearing up for a major depression while the stock market was soaring into the stratosphere?

Mr. Sprinkel. No, sir. The stock market dropped ahead of the beginning of that miserable, long depression, and it dropped a lot, as you know.

Senator **Sarbanes.** I take it your point was that the market isn't actually going up at the time the depression happens; is that correct?

Mr. Sprinkel. At the time of the beginning; that is correct.

Senator **Sarbanes.** But in 1929 the market was going up, and then the market went to pieces and behind that came the depression.

Mr. Sprinkel. Yes, sir, that's correct.

Senator **Sarbanes.** That's a potential scenario for the situation in which we find ourselves, is it not?

Mr. Sprinkel. I do not believe so. I see none of the usual evidence, not only including the stock market, but a lot of other factors that usually develop prior to the beginning of a recession. I spent a lot of my time in private forecasting, and not doing perfectly there either, trying to anticipate cyclical terms, and there tends to be a set of characteristics at least that begin to show up before you get into trouble. Sometimes the leads vary and that's why it is difficult to forecast precisely, among others.

The stock market is one, but also interest rates and inflation. Inevitably in the latter phase, at least in the past, of an economic expansion you find that inflation begins to rise and interest rates go up and that begins to choke up some sectors of the economy and inventories become excessive in relation to sales. None of those factors are showing today.

Now I don't mean to say that all the problems of this Nation are solved. They are not. All I'm saying is that there is no evidence available at the moment that I'm aware of that suggests we are on the verge of moving into a recession, and certainly a recession is contrary to our objectives. Some have suggested that as in the past the way we can solve our trade deficit is to put the economy in a tailspin and go into a recession. That is typically the way a trade deficit has been corrected by other countries in other times, but that is not our objective.

We are trying to pull off something much more beneficial, but also difficult, and that is why we need help from our colleagues abroad as well as putting our own financial house in order.

Senator SARBANES. Jim, we won't take it out of your time. Go ahead. [Laughter.]

Representative SCHEUER. Thank you, Mr. Chairman. Mr. Sprinkel, it's a pleasure to have you back here.

Mr. SPRINKEL. Thank you, sir.

Representative SCHEUER. You do point out a number of encouraging factors, the 12 million new jobs, inflation going down, interest rates are down and business investment is up. But we know there are some perplexing problems, and you admit them. You talk about not only sectoral and the Middle West, the problem of the farm economy and the problems of our industrial society, but you also talk about structural problems.

One of the structural problems that I think concerns a lot of people that you didn't take the occasion to address is the problem of what those 12 million new jobs in 4 years represent. I think it was 12 million new jobs in 4 years. Yes, 3 million jobs a year.

Some of us are concerned that we are losing high-paying industrial jobs and replacing them with low-paying service jobs, McDonald's jobs, and that we are deindustrializing America and that American industry and certainly auto and steel are having desperate problems in competing with foreign producers and in textiles and clothing, all the sectors that you are very familiar with.

How long can we permit this process of deindustrialization to go on? How long do we want to exchange high-paying, productive jobs for low-paying service jobs, and what do you see are the core problems that are crippling us in our ability to compete, not only with old competitors, German, Sweden, the Scandinavian countries, and Japan, but newer competitors in Asia, too, Malaysia, Hong Kong, Singapore, and South Korea. We are seeing automobiles coming in for the first time in the last year from South Korea.

How do we get our industrial productive act together so that we don't become a nation of people who are serving each other hamburgers and taking in each other's laundry?

Mr. SPRINKEL. It's a fascinating set of questions. Some of what you've said I certainly agree with and support. There are some other parts that I would like to raise some questions about.

One is the so-called deindustrialization of America. I read articles and hear speeches on this subject. Then coming from Missouri I tend to go back and look at the numbers to see what kind of support there is for these arguments, and there isn't much.

In the first place, industrial output as a percentage of GNP has held in there very well. It's even higher than it was some periods back, and it's true that over a long period of time that the employment has persistently, long ahead of recent years, shifted gradually from the manufacturing to so-called service production, and that trend continues. There has been no reversal in that.

Representative **Scheuer**. And that is a troublesome trend, is it not?

Mr. **Sprinkel**. Well, it's not troublesome in this sense. These are aspects that are troublesome, but it reflects continued significant productivity improvement in the industrial sector of the economy. I cited in my prepared statement what in fact has been happening to productivity growth in the manufacturing industry.

Now I should point out that the measured productivity growth over in the service industry as we measure it has not been nearly as favorable. It has improved some, but it's not nearly so favorable as it is in the manufacturing area, and we don't know for sure whether that is because we can measure one and can't measure the other or is it really true that this is happening, and I suspect it is happening to some extent.

I am not concerned about deindustrialization in the sense that our industries are just going to wither away and we will all be in the service business. There is no evidence to support that that's happening.

Furthermore, even though this productivity has been very good in recent years, in 1981–84 and up until 1985, the effective competitiveness, that is the international competitiveness of our producers went down, down, down, that is adjusted for the exchange rate that occurred. Despite good productivity improvements, they were less and less competitive.

Now beginning and only beginning in the early part of 1985 and continuing up until the present productivity has continued to improve, but the dollar has adjusted, so that adjusted for international competitiveness we're looking better. There is no evidence yet that we've solved that problem because we still have a very large trade deficit about which we talk.

I think we are on the verge of moving in the right direction, and the President feels as you do that there are things that we can do to further improve the productivity of the American economy, and he will be sending up a sizable package and we hope to work with Congress in furthering those kinds of efforts that will further improve productivity, raise standards of living and the opportunity of Americans and also improve our ability to compete abroad.

So the other point you made, there has been a paper published in this town, and I do not have either the title or the author in mind, within over the last month or two presenting some evidence that it's growth in low-paying service jobs and it's loss in high-paying jobs. I have docketed on my calendar to review that paper. We have been writing the President's Economic Report. There is some truth to it, but I suspect not nearly so much at least as the headlines suggest.

I'm in the service business, you're in the service business, and I know a lot of highly paid people that are in the service business in banking and other areas. We do want to do some work on seeing what that change in mix in fact has been.

Representative SCHEUER. Just one very brief question. When you talk about the administration's keen desire to improve productivity, would you state that the fact that we have a third of our adult working population illiterate, and therefore, incapable of reading a job instruction sheet and incapable of using sophisticated technology would be an obvious target of opportunity whereby we could improve not only our national social, economic, and political health, but our ability to produce and be an effective competitor in global trade? And if you do think that, does the administration have any significant plans to attack the problem of adult illiteracy?

Mr. SPRINKEL. A portion of the total package that deals with competitiveness improvement does address that very issue as an important one, and we believe that much can be achieved and should be achieved.

I do not want to suggest that we are going to be coming up here with a multi-billion dollar Federal program for subsidizing education. We think that that is not the proper way, that this is primarily a State and local area problem, but we, the Federal Government, have a responsibility to provide the leadership and that is a portion of the total package.

Representative SCHEUER. Thank you, Mr. Chairman.

Senator SARBANES. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman. Mr. Sprinkel, let me just say that I take exception with the administration's position on trade reform. I know that you refer to it as protectionism as does the President and as does your Economic Report, but as one who has been involved in this issue since I've been in Congress since 1979, I've become very frustrated with the process.

I represent a number of industries that have fallen because they have not been represented adequately by our Government or our trade process.

Frankly, I think that there is a difference between fairness and protectionism. I see a difference between competitiveness and trade reform, and I think that we need to see legitimate changes in our trade process.

I could cite you example after example, but let's take the case of the shoe industry that went through the process that went through the International Trade Commission, and the ITC recommended relief for that industry only to be rejected by the President. Unfortunately, that bill did pass the Congress, but was vetoed by the President and we fell short by eight votes in the House of Representatives of overriding that veto.

But, nevertheless, where do we draw the line concerning unfair trade policies that are practiced by other countries? We know what they are and we have identified them in the past.

We have had problems with Canada, and the fishing, lumber, and potato industry in Maine have suffered adversely because of Canadian policies. I know you referred to the free trade negotiations, and I have real concerns about that, because if we do not eliminate the artificial barriers that exist within that country in support of their industries, I think it is going to work to the detriment of our industries.

I hesitate to mention Canada to you because I noticed on your briefcase that you have a maple leaf which is the Canadian emblem. I hope that doesn't symbolize the administration's position. [Laughter.]

Mr. SPRINKEL. That was from a World Bank meeting in Toronto in 1982. You are correct. [Laughter.]

Representative SNOWE. I hope that isn't symbolic. [Laughter.]

But in any event, I would like to have you address that question because it's a concern to me and it's obviously a concern to a number in my district and throughout this country. I think that we have mixed so much of the lingo. We talk about competitiveness today and that seems to be a new word in this town. But, on the other hand, we still need some legitimate trade reform to protect our industries when they deserve relief.

I can cite again industry after industry that has tried to get relief from the administration or through the existing trade process and has been denied that relief, and I see that difference. So I would like to know what is the administration going to support in the way of trade reform, because I think that that is first and foremost, and I do not describe it as protectionism. It's far from it. It's fair play, and you can't compete if it isn't a two-way street.

Mr. SPRINKEL. I can understand your frustration, especially if some of those losing firms and industries happen to be located in the part of the country you live in. Some of them were located in the part of the country I used to live in.

We of course have a system of checks and balances that you are well familiar with, and the President and the Vice President are the only ones that are elected by all of the people in the United States. This particular President is very concerned that he represent not only the producers but also the consumers, and there have been occasions, you referred to one, when the judgment was that international trends and domestic trends being what they were, that it would be inappropriate to provide protection. I know you don't like the word "protectionism," but at least we can say protection, for an industry that was unable to compete, and to do so would have meant several billion dollars added to consumer costs.

President Reagan's viewpoint has been from the beginning and continues as of now that he wants free and fair trade, as you do, at least you want fair trade, and that he will go to great lengths to keep our markets open so as to avoid hurting the American consumer and the American voter, but at the same time insist on opening markets abroad.

In that report you will find a sizable number of pages devoted to some action that he is the first President in history to take through self-initiated 301 cases brought specifically because we believe there were unfair trade practices. We discuss each of those cases that President Reagan has initiated and the results. There is of course one pending that is coming down to the final hour in the next 2 to 3 days, and that of course is with the EC.

We discuss not only the advantages of using the 301 instrument, but also some of the risks. It's not a risk-free activity. That doesn't mean we shouldn't use it on occasion, but we should at least be aware of the risk.

We also talk about work that we have done in other kinds of arrangements to open markets, the so-called "MOSS" talks with Japan. The first such talk I headed from the United States that is, headed our delegation. It was the efforts to open Japanese capital markets which were closed tighter than a door.

Considerable progress was made and that was followed by several additional MOSS discussions, and again in each case, some more than others, some progress was made in opening the markets. We also discussed the bilateral negotiations which you referred to with Canada. We have a free trade arrangement with Israel. We are working very hard because we believe it's in our interest and in their interest to have a free trade area with Canada.

Finally, we devote considerable attention to what I think is by far the most important move, and that is to move into a new GATT round on a multilateral basis, especially after we succeeded in getting on the agenda some items that we believe are extremely important for American producers. That includes such things as better ground rules for service trade, and we are rather large in that business, as you previously pointed out, and we are large internationally as well, better ground rules for agricultural trade and better ground rules for intellectual property.

So I think the basic thrust of our administration has been correct, consistent, and I believe well understood, but I also perfectly well understand that it seems unfair to some.

Representative **Snowe**. Well I appreciate your comments here today. I know that in the report and in your remarks you express concern for the American consumer, but I would also suggest that you have to earn a wage before you can become a consumer.

Frankly, during the quota period between 1977 and 1981 for imported footwear the price of shoes did not rise.

I also take exception to the $44 billion it has cost American consumers if the textile bill had passed the Congress. CBO had said maybe $1.4 to $7 billion. It was interesting during the course of that debate when we received, each Member of Congress received a T-shirt of sorts. The same price was paid in this country for the T-shirt that was manufactured here, and the exact same T-shirt was manufactured in Taiwan for the same price. The price has not been realized by the American consumer in spite of the overwhelming imports in this market from footwear producing countries.

So I see it as a real concern, and I think that is why we have a major trade bill, or it's going to be before us this time because of the hesitancy of this administration to deal with that issue. I say it because I feel very strongly about it and I see the real distinctions between the issues of fairness and protectionism and competitiveness.

Mr. **Sprinkel**. If I may add, we hope that we can work with Members of the Congress to come up with a bill that will indeed improve the ability of our producers to compete abroad and at the same time avoid the mistakes of zapping our consumers by reducing the array of goods and services available and also causing the prices to go up sharply.

Representative **Snowe**. Thank you.

Senator **Sarbanes**. Senator Melcher.

Senator **Melcher**. I am pleased to follow right up on your statement. You said you would be glad to work with the Congress on trade. Let me tell you that I've been trying to work with this administration on agricultural trade for the past 2 years very diligently and I'm having a difficult time in ever getting through to anybody very meaningful and establishing an expansion of exports rather than a constant contraction of agricultural exports.

I've read through your chapter here in the Economic Report of the President on agriculture; it's chapter 5. Is there a lead author that comes to your mind for this particular chapter?

Mr. **Sprinkel**. Yes, sir. Let me make a brief commentary, if I may, and then I would like to pass it to Mr. Thomas Moore of the Council who specializes in microeconomics, and one of the areas of his expertise is agriculture.

I was born and reared on a farm, sir, and I remember when those programs started in the early 1930's, and instead of getting better, I think they have gotten worse, much more costly and we need to help the farmer who is hurting.

Our proposal, sir, as you know, is to gradually decouple the production of agricultural products and over time to move back to a market oriented agricultural production which is what existed when I was young.

But I would like to turn that over to Mr. Thomas Moore, sir, and let him elaborate on the subject.

Senator **Melcher**. I will get back to you, Mr. Sprinkel, but let's move ahead, Mr. Moore.

Mr. **Moore**. The problems in international trade in agriculture——

Senator **Melcher**. No, the question was who wrote the chapter.

Mr. **Moore**. Well, our chief staff economist in this area was Gordon Rausser.

Senator **Melcher**. Pardon me.

Mr. **Moore**. Gordon Rausser.

Mr. **Sprinkel**. Supervised by Mr. Moore.

Senator **Melcher**. Let me say this. I think it's a useful chapter and very good reference material and rather concise, and I appreciate that.

Now one part of it says that the 1985 farm bill isn't working, and I think there are stronger terms in there. Maybe it says it's a failure. It all means the same thing.

When we passed the 1985 farm bill the President was jubilant, if I can interpret the reaction on his face as he signed it with quite a bit of fanfare.

Most of us here that worked with it in Congress were cognizant and kept saying that it might work and it might be a good bill if agricultural exports picked up because it continued the policy as a congressional policy and as an administration policy of rather large production. Exports have not kept up and instead they have continually declined, or continued the decline that had already started prior to 1985. So my questions are along this line.

This section or this chapter concludes that we should continue to follow the policy of relatively large agricultural production. On page 173 it says, "Attempts to limit supply failed to exploit the continued growth in world food markets." Now I agree with that and I believe in that, but I can't get any action out of this administration that reflects that. Do you know anything about that, Mr. Chairman?

Mr. **Sprinkel**. We do plan, sir, to produce some suggestions for amendments and changes in the farm bill. They will not include massive increases in set-asides which would be inconsistent with that statement.

Senator **Melcher**. My time has expired and we'll get back to it in the next round.

Senator **Sarbanes**. Senator Bingaman.

Senator **Bingaman**. Thank you very much, Mr. Chairman. Mr. Sprinkel, let me just ask about one of the charts or tables that is connected to your report on page 278, table B-29, and ask if you could just explain to me the reasons for some of the figures I'm going to cite to you.

I just want to see if I'm, first of all, understanding the table.

As I understand the tables, it tries to take 1985 dollars and calculate the median income of people, first families and then individuals.

As I read it, in 1979 there were 5.5 million families below the poverty level, and today, or at the end of 1985, there are 7.2. There were 26.1 million individuals below the poverty in 1979 and today there are 33.1 million. The median income for a family has dropped from $29,029 in 1979 to $27,735 at end of 1985, and the median income for males has dropped from $17,457 to $16,311.

If I'm reading this correctly, maybe you could just explain what the causes are for the very significant drop in median income in the last 6 years and the very substantial increase in the number of people below the poverty line during that same period.

Mr. **Sprinkel**. The substantial drop in median income that you refer to I'm still looking for. It's $17,153 in 1979 and it's $16,786 in 1985; is that correct?

Senator **Bingaman**. Well, the one I'm looking at says in 1979, under all persons, male, it says $17,457 and at the end of 1985, $16,311.

Mr. **Sprinkel**. Now I see what you're looking at. All persons, male, $17,457 to $16,311 in 1985. I cannot off the top of my hat give you an explanation. We will be glad to take a look at this data. What we did, the only way that we touched upon this in our analysis for the Economic Report was to look at what happened to wage rates for women relative to men and also black and other relative to both men and white women. In that case the rise in women's wage rates, they rose more rapidly than the rise in men's wage rates and the black and others rose even more than white women. But I have not analyzed this data. Do you want to say something about it, Tom or Mike?

Mr. **Mussa**. Well, I know from talking to our staff people that there is a great deal of concern as to the reliability of some of this data and the measures of what the poverty standard constitutes.

One of the difficulties in interpreting it is that we have seen an important change in the structure of poverty. It used to be the old-age population which had a relatively high proportion of poor people in it, and now that has shifted and it tends to be younger aged people, particularly in families where there is only one parent present where the poverty rate has been rising.

Now one of the things which is noteworthy in these figures is that for females the real per capita income in 1985 dollars has gone up a little bit, while for men it has come down. For families as a whole the median income has come down a little bit.

But there are also some difficulties with the extent to which Government benefits are included in the measure of family income. Certain types of Government benefits are not included in the level of family income which is quoted here, and that makes the living standard, which is represented by given family income, change a bit over time as the impact of nonincome sources of the living standard changes.

Senator Bingaman. Let me just ask if there are problems with these figures, ~~as~~ you seem to indicate there are, could you get us more reliable figures on what has happened to the wage rate and to the average weekly wage of the American worker in the last 6 years or in the last 10 years?

My understanding is the average weekly wage of the American worker has dropped about 13 percent since 1973. Are you able to either confirm or deny that?

Mr. Mussa. Well, again, we need to be very careful about what is going on here. The number of part-time workers in the labor force has increased as a fraction. The number of women in the labor force has gone up and the number of workers who seek part-time work as their desired outcome has gone up as well, and that is an important part of the explanation in the decline of average weekly wages for all workers. If one looks exclusively at full-time workers, then the decline is much less pronounced.

Senator Bingaman. Well, my time is up. Maybe if you do have more accurate statistics than are reflected in this particular table, I would appreciate getting them.

Mr. Mussa. That's of course for families below the poverty line. There are other tables in the report which deal with wages more generally for the work force.

Senator Bingaman. Let me just ask, these median income figures are for all families, unless I'm misreading this.

Mr. Mussa. I've lost my page.

Senator Bingaman. It's page 278. I think the median income, according to this table, has dropped for all families. Am I misreading this?

Mr. Mussa. There are very considerable problems with the definition of a family. Per capita real income has risen even though the definition of family income shows a decline, and that has a lot to do with who is defined to be in a family unit.

I think if you speak to the people from BLS, they will tell you that they think the per capita income figures are a more reliable indicator than the family income figures because there is not this problem of defining what constitutes a family unit.

Senator Bingaman. My time is up, Mr. Chairman.

Senator Sarbanes. I think actually Senator Bingaman has opened up something that I wanted to comment on. Of course we have not yet had a full opportunity to digest the Council's report. It seems to me that at sometime in the future a purpose would be served by having the Council back before us, so that we could go into much greater detail with respect to many of the matters contained in the report, and probe further into the sorts of questions that Senator Bingaman has just raised and I know that other members may have.

Mr. Sprinkel, I worked for Walter Heller for a little over a year when he was Chairman of the Council.

Mr. **Sprinkel**. I knew that.

Senator **Sarbanes**. So I have some interest in the health of the Council of Economic Advisers. I say that because for 9 months before you became Chairman there was no Chairman of the Council of Economic Advisers. For 3 months there was only one member. Then, and I think this is accurate, a couple of months after you took over, you picked up one member, and then went for over a year with the other position vacant. That's roughly correct, I think.

Mr. **Sprinkel**. The date is in here.

Senator **Sarbanes**. It's on page 230. I was looking at it. How badly has the Council been hurt by this as a professional organization?

Mr. **Sprinkel**. I do not believe it has been hurt at all. I have known all of the prior Chairmen I believe except one, including Walter who is a good friend of mine. As a result of promises made to me by the President and Mr. Regan who was moving from Secretary of Treasury to Chief of Staff, I received a promise that the Council would be fully restored in terms of personnel that had been cut, some voluntarily and some otherwise, and that we would be wired back into the decisionmaking process in the Economic Policy Council and the Domestic Policy Council and have access to the President and other important members of the Cabinet.

That was done and we have been extremely busy, but it has been very exciting. We have ample opportunity to make our contribution and we do so. We have made a difference. I think the prospects for the Council are very good. It's approximately, Senator Sarbanes, the same size that it was when it began in 1946 in terms of numbers of people and we plan to keep it that way. We are probably the only agency of Government where that's true.

I hope the efficiency has gone up because we do have computers and the latest state of the art facilities to work with. But we have not had difficulty in attracting people. We attracted Mr. Mussa rather promptly, but he had complicated forms to fill out and it took a while. [Laughter.]

I was concerned that we might not be able to get really topnotch, senior staff people because they are the ones that really make a difference. We have 12 of them.

Senator **Sarbanes**. Had the Council experienced that problem in the period immediately before you took over as Chairman, and before these arrangements that you made reference to were worked out?

Mr. **Sprinkel**. I had the impression that there had been some reduction in the access and participation in important policy decisions in the administration. I can't be certan of that because I was not directly involved. All I can tell you is that in my case I haven't been excluded. I've been included, and that's the way I wanted it.

We participate not only at the Council levels but also down below in the working groups. We frequently come up with ideas and we wrestle it through the process and on up to the President who has to make the ultimate decision.

So I don't feel any lack of competent people. We have had a sizable number of highly competent people qualified to be senior economists that want to get on the staff and we are just now appoaching the season where we have to start again.

As you know, Senator Sarbanes, the Council of Economic Advisers tends to rotate normally. They would come in, the senior staff people, for 1 to 2 years usually and then move back to Government business or academia, mostly academia, but not all, and we are just beginning to think about the new crop because some of them will be going back. But we have had I think really top-notch people involved at both the senior and the junior and we have a few staff that are in the middle. So I have been delighted.

Senator **Sarbanes**. As part of this being wired back in, did you have to make any understandings as to how you would call the shots, in terms of your judgment about economic matters?

Mr. **Sprinkel**. No, sir, I did not, and I would not have. If my reputation is on the line, as it is, I will go with that reputation and I will do my dead-level best to tell the President what I believe, and I do so, and I will continue to do so.

Senator **Sarbanes**. How is economic policy made in the administration? In other words, is there a group like yourself and, say, the Secretary of the Treasury and maybe the head of the OMB that functions on a regular basis, as sort of the economic policy counselor to the President?

Mr. **Sprinkel**. Let me talk first about the formal and then some informal networks which inevitably, I'm sure, have existed in prior administrations.

The formal one, as you know, are the three Councils, the Economic Policy Council chaired by Secretary Baker, the Domestic Policy Council chaired by Ed Meese, the Attorney General, and the National Security Council I presume chaired now by Mr. Carlucci, although I am not a member of that latter one. Once in a great while we participate if there is an economic issue.

Senator **Sarbanes**. Actually I think the NSC is chaired by the President and in his absence the Vice President.

Mr. **Sprinkel**. That I think is literally true of all except the persons that are there most of the time are the senior people and the ones I named. I'm not so sure about NSC because I don't go to that one regularly.

The issues may come from working groups, it may come from members of the Council or they may come from the President, but they are worked on in the working groups taking the issues, laying out the potential solutions and arguing the pluses as well as the minuses. Then a paper is prepared for the Council members. We get together and discuss it and argue it. Sometimes it's unanimous, but I think that is rather unusual. Then we go before the President and argue it again and he makes a decision. That is the formal process.

Now you asked about a small group in the economic policy area. I think it's been true for many years, but we have regular break-fast meetings of that small group where we discuss what we think are important issues coming up.

Senator **Sarbanes**. Who makes up that small group?

Mr. **Sprinkel**. Well, it varies. I think it would be improper for me to say, but you've gotten most of them in your rundown.

Senator **Sarbanes**. How often do you yourself meet with the President on economic policy?

Mr. **Sprinkel**. Well we meet three, four, or five times a week typically.

Senator **Sarbanes**. You mean four or five times a week yourself with the President?

Mr. **Sprinkel**. Yes, sir, and it's usually with a small group or a slightly larger group and it's seldom alone. I met with him just before we came over here, as you well know.

Senator **Sarbanes**. Do you meet with the Chairman of the Federal Reserve on any regular basis?

Mr. **Sprinkel**. Yes, sir. We have luncheon meetings regularly with the Federal Reserve Board.

Senator **Sarbanes**. I keep asking "you" and it keeps getting transformed to "we." So if you could tell me who "we" is?

Mr. **Sprinkel**. Well, we in this case, and I'll be very frank, it's all members of the Board that are available and all members of the Council of Economic Advisers that are available, and I talk with members of the Federal Reserve Board several times a week.

Senator **Sarbanes**. And you have a weekly meeting between the Council and the Board?

Mr. **Sprinkel**. No, sir. That meeting is monthly.

Senator **Sarbanes**. My final question: Is your budget adequate to meet your responsibilities?

Mr. **Sprinkel**. I think so. We have a problem that I don't want to complain about because we are managing it, but I have to be honest in responding to your question. We had restored to us the personnel that were pulled out before I came into CEA and, unfortunately, they gave us enough money to hire clerks but not senior economists. So we've had to scramble, but we're making it.

We do not want to balloon that budget and we don't want to increase numbers over what we have, but we now have 12 senior economists and 6 junior—well, 6 junior or staff economists. There are two of them that just received their Ph.D. recently and we moved them up to staff, but then there are four juniors. Then we have some research assistants, some regularly, but others have come in in crunch periods, plus the professional—there is at least one still there that was there when you were there in the statistical area, and we have good coverage of secretaries. So on the whole I think we are managing it very well in terms of adequate resources.

Senator **Sarbanes**. Thank you.

I want to note that Senator D'Amato was with us earlier but had to leave for another hearing, but he had an opening statement which he wished to have included in the hearing record and that will be done.

[The written opening statement of Senator D'Amato follows:]

WRITTEN OPENING STATEMENT OF SENATOR D'AMATO

MR. CHAIRMAN, I WANT TO WELCOME TO THE JOINT ECONOMIC COMMITTEE THIS MORNING OUR DISTINGUISHED PANEL OF WITNESSES WHO WILL SHARE WITH US THEIR OPINIONS ON THE PRESIDENT'S 1987 ECONOMIC REPORT. AS THE CONGRESS CONTINUES TO GRAPPLE WITH OUR NATION'S ECONOMIC PROBLEMS, I, FOR ONE, WELCOME YOUR VIEWPOINTS.

DURING THE LAST FOUR YEARS WE HAVE WITNESSED THE POSITIVE EFFECTS OF OUR CONTINUED ECONOMIC EXPANSION. WE HAVE SEEN THE PRIME RATE REDUCED TO 7.5 PERCENT, THE DISCOUNT RATE LOWERED TO 5.5 PERCENT, AND MORTGAGE RATES DIP BELOW 10 PERCENT. IN ADDITION, AMERICAN CONSUMERS HAVE BENEFITTED FROM THE HUGE DROP IN OIL PRICES AND THE FREQUENT RECORDS SET ON WALL STREET. JUST LAST WEEK, THE U.S. DEPARTMENT OF LABOR REPORTED THAT CONSUMER PRICES ROSE A MERE 1.1 PERCENT LAST YEAR --- THE SMALLEST INCREASE IN PRICES FOR GOODS AND SERVICES IN 25 YEARS.

OUR CURRENT ECONOMIC EXPANSION, PRESENTLY IN ITS 5TH YEAR, HAS EXCEEDED FIVE OF THE SEVEN PREVIOUS POSTWAR EXPANSIONS IN DURATION, AND LEADING ECONOMIC INDICATORS POINT TO CONTINUED GROWTH AHEAD.

WHILE WE HAVE EVERY REASON TO ENJOY OUR CONTINUED PROSPERITY, I AM TROUBLED BY OUR GROWING FEDERAL BUDGET AND TRADE DEFICITS. IT IS ESTIMATED THAT THE ANNUAL TRADE DEFICIT FOR 1986 WILL EXCEED $175 BILLION. THIS UNPRECEDENTED DEFICIT CONTINUES TO BE A SOURCE OF CONCERN TO ME AND I LOOK FORWARD TO THE TESTIMONY OF OUR WITNESSES AND HOPE THAT THEY WILL PROVIDE SOME INSIGHT INTO THE RESOLUTION OF THIS DILEMMA.

THANK YOU, MR. CHAIRMAN.

Senator SARBANES. Senator Melcher.

Senator MELCHER. Mr. Sprinkel, just picking up where we were before, let me assure that there is much that you have stated yourself here this morning and is in this report that I agree with.

For instance, you said you grew up on a farm in, I believe, Missouri?

Mr. SPRINKEL. Yes, sir.

Senator MELCHER. Times haven't gotten very much better and are probably a lot worse for people in Missouri in farming. I agree with that. I have had the same experience. I have been around agriculture all my life and I have been trying to understand these farm programs most of my adult life. I'm not a big advocate of farm programs. I've voted on them for the past 17 or 18 years since I've been here in Congress and I generally vote for the best alternative not having much confidence in it being too successful.

I think we also agree on reduction of the $26 billion that was paid out last year out of the Treasury in the farm program, that that's much too high.

And I do agree with the thrust of this chapter that we should continue with agricultural policy for the United States of fairly large production of commodities.

Now I want to tell you a couple of things we don't agree on, and one is I don't agree with you at all on the reduction of target prices and I'm telling you that because there is no use in putting that into some sort of a model. That's law, and whatever the law requires in reduction, and there is some reduction in the years you cover here in your report, that's very likely where it's going to stay. So I'm not trying to build a model based on something that isn't going to happen.

Second, I don't agree with you on whatever you're talking about decoupling, because all that has been expressed is so vague that nobody knows that it means. The President says he's going to send up a bill, and when we get a bill we'll look at whatever he defines decoupling to mean.

But I hope you are not thinking that that's going to do much, and I'm sure you're not. We agree on this, that you are not going to do much on decoupling within the next couple of years, that that's down the road. So we don't have to talk about that.

Now I also agree with the thrust here that we ought to be ready to expand exports and should do it. My problem is I don't think the administration knows how to do that, and now I'm going to ask you.

We had a provision in in the 1985 farm bill for a Special Adviser to the President on Agricultural Trade and Food Assistance. Have you ever met him?

Mr. SPRINKEL. Not that I'm aware of. Now there was an agricultural person that joined one of those committees in the White House recently, but I think that's different.

Senator MELCHER. What level are you at?

Mr. SPRINKEL. What level am I, sir?

Senator MELCHER. Yes.

Mr. SPRINKEL. I guess there is a designation of two.

Senator MELCHER. He's two also. Now this is what bothers me. He's there, and I know he's there. I had lunch with him last week downstairs in the mess or whatever you call it, the White House mess. He's there.

Mr. SPRINKEL. Good.

Senator MELCHER. He had no input into this book?

Mr. SPRINKEL. Not into that book, no, sir.

Senator MELCHER. And he is the Special Adviser——

Mr. SPRINKEL. It's my responsibility to do the book with the help of the White House advising and others around and members of the Cabinet, but ultimately it's the Council.

Senator MELCHER. Mr. Sprinkel, do you know the procedure of this administration, the previous administration, and the previous administration to that and maybe two or three more going back 20 years? Do you know the procedure of approving an export?

Mr. SPRINKEL. Of approving what?

Senator MELCHER. An agricultural export where you extend credit, so-called GSM——

Mr. SPRINKEL. I do not know all the detailed procedures, no, sir.

Senator MELCHER. Well, let me tell you it's very complicated. I'm not going to ask you, but I'm just going to assume you don't know the procedure of approving Public Law 480, food for peace shipment. Is that assumption correct?

Mr. SPRINKEL. That is correct.

Senator MELCHER. Let me tell you, it's so involved. It's so involved and convoluted that that was the reason for putting the Special Adviser mandated by law to the President in the 1985 farm bill.

Now when I said that I've been trying for over 2 years very diligently to pursue with the administration some opportunity for agricultural export expansion, and I'm telling you that in all sincerity. I've been a player up here for much longer. I've been an active pursuer with the administration for more than 2 years and what do we do to make it easier. I'm looking for an ally. I'm looking for your group as an ally.

You don't know the Special Adviser to the President on Agricultural Trade and Food Assistance, and I'm not surprised, but neither does the President know much about this and he needs a lot of advice.

This problem we're in, whether decoupling or anything else we want to talk about in new legislation really doesn't have much impact right now. The problem we're in is that we have these surpluses that continue to mount, and I believe you understand that as the target price is set by law and the surpluses mount and the world price falls that the target price set by law causes the deficiency payment to the producer to be larger and that is why we've got $26 billion.

The only way to get at it immediately is to reduce the surplus and let the world price at least stabilize on commodities or perhaps inch upward. That's the only way to quickly reduce the Treasury outlay.

Might we have some interaction between at least some members of our Agriculture Committees and your group?

Mr. SPRINKEL. Yes, sir. We would be very pleased to.

Senator MELCHER. And the Special Adviser on Agricultural Trade.

Mr. **Sprinkel**. As you know, the Department of Agriculture has the lead on agricultural policy and we have worked with them in preparing this report.

Senator **Melcher**. Well, I hate to disappoint you, but all too frequently the lead department on agricultural trade is the State Department and there are reasons for it, but there is no reason for us to allow the interaction of these various groups to hold up decisions.

Mr. **Sprinkel**. Yes, sir. You mentioned the complexity of Public Law 480, and I'm positive that's true because I've seen some of it, but I don't understand all of it. This is one reason why it seems to me that it's very important to get back to market orientation and not Government determining it, because any time you get it into the bureaucratic process in detail it gets more and more laborious and complicated.

Our proposal of gradually moving toward the marketplace will remove the necessity for many of these complicated procedures. We say gradual because I think one of the major reasons agriculture has a problem is past farm programs, and it would be highly inequitable and very foolish to suddenly pull the rug out and let them sink or swim, and we are not proposing that nor would the President propose that.

Senator **Melcher**. Again, Mr. Chairman, that's down the road a couple of years, 3, 4, or 5.

Mr. **Sprinkel**. Yes, sir, but we have to start.

Senator **Melcher**. What I'm talking about is here and now. I'm talking about the last 2 years of this administration, of this President's reign, and I think we can make it a little more successful. I'm asking you in good faith and in all sincerity to within your group to allow us to show you what can be done now and maybe working together we remove some of this redtape so it can start to flow.

Mr. **Sprinkel**. Yes, sir. We'll be very pleased to if you'll let us know when.

Senator **Melcher**. Thank you very much. My time is more than up, and Senator Bingaman will take over.

Senator **Bingaman** [presiding]. Mr. Sprinkel, could I just ask about one other chart. The Chairman had to duck out for a phone call and said that we should adjourn the hearing after that.

The chart is on 293 and it's table B-42. The second column which refers to total private nonagricultural average gross weekly earnings. As I read that it reflects a drop in gross weekly earnings in this country really from about 1973 until pretty much the present from $198 per week to $171 per week.

I guess my question is whether you view that as a cause for concern?

Mr. **Sprinkel**. Well, obviously we would like to raise the standard of the American public more rapidly. Now real disposable income has been rising. It hasn't been soaring, but it's been going up along with the increase in employment, but it apparently by this particular series, that is 1977 dollar average gross weekly earnings, it's come off a little bit during that period. Yes, that's a concern and that is why we want to improve productivity, and therefore, higher wages.

Senator Bingaman. It's come down 13 to 14 percent, hasn't it, or am I misreading that chart?

Mr. Sprinkel. No, it could well be.

Senator Bingaman. $198 down to $171; I don't have a calculator, but that's nearly 15 percent by any calculation, I think.

I guess my thought is, is the explanation for that the one that was offered before when we were talking about the median family income, that more and more people wanted to work part time? Is that part of the explanation here?

Mr. Mussa. There are two aspects to it. One is that there has been an increase in the fraction of part-time workers. The other is that the demographic structure of the labor force has changed substantially. So the number of younger workers and relatively less experienced workers, which includes an increasing number of women who have recently entered the labor force, their average weekly earnings have traditionally been well below those of men who used to predominate in the work force, and as those demographic changes occur, then that affects what the average weekly wage is in addition to what the effect is of part-time work.

Senator Bingaman. But do you see this as an indicator of a drop in the standard of living of the average American during that same timeframe?

Mr. Mussa. No. I think the best measure of standard of living is really on page 275 where we get per capita disposable income in the second column in 1982 dollars. There we see that in 1986 the provisional estimate is certainly above that of any preceding year and comparing it to 1979 per capita real disposal income, there it is $2,600 in 1986 versus $2,200 in 1979. I think that's really the figure that indicates best what's happening to real living standards of the average American.

These figures on average hourly earnings and on family earnings are affected by changes in the demographic structure of the labor force or the definition of what constitutes a family unit.

Senator Bingaman. I think in light of the fact that everybody else has left we will adjourn the hearing. Thank you very much. We appreciate your being here.

Mr. Sprinkel. Thank you, sir. It was our pleasure.

[Whereupon, at 1:25 p.m., the committee recessed, to reconvene at 10 a.m., Friday, January 30, 1987.]

THE 1987 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, JANUARY 30, 1987

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to recess, at 10 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes, Proxmire, Melcher, and Bingaman; and Representatives Hawkins, Wylie, and McMillan.

Also present: William R. Buechner, professional staff member.

Senator **Sarbanes**. The committee will come to order.

Before I turn to today's business, let me simply announce that the Joint Economic Committee met yesterday and organized officially. I'm honored to have been chosen as the chairman of the committee for the 100th Congress. Congressman Lee Hamilton of Indiana will be the vice chairman and Congressman Chalmers Wylie of Ohio will be the ranking minority member.

I also want to welcome to membership on this committee for the first time Congressman Alex McMillan of North Carolina, who is being joined on the Republican side in the House by Congressman Hamilton Fish of New York. There is one vacancy for a House Democratic member on the Joint Economic Committee that's not yet been filled.

On the Senate side we have two new members, Senator John Melcher of Montana and Senator Jeff Bingaman of New Mexico.

Today's hearing is a continuation in the hearings of the Joint Economic Committee with respect to the President's Annual Economic Report. We are very pleased to have with us this morning the Secretary of the Treasury, James Baker.

Mr. Secretary, we understand the time pressure you are under and we will try to get you away some time between noon and 12:30, which I understand would meet your scheduling problems.

In view of that, I'm going to defer any substantive opening statement, but I do want to say that the Joint Economic Committee, since its establishment in 1946 under the Employment Act, has had a positive and constructive relationship with successive Secretaries of the Treasury. The Secretary of the Treasury is invariably, after all, the point man in all administrations with respect to economic policy. That's an important relationship which has continued and in fact been enhanced with Secretary Baker, and we are very pleased to have him before the committee this morning.

Mr. Secretary, we are prepared to hear your statement, while I defer for a moment for any other opening statements.

[The written opening statement of Senator Sarbanes follows:]

WRITTEN OPENING STATEMENT OF SENATOR SARBANES

This morning the Joint Economic Committee continues its annual hearings in conjunction with the Economic Report of the President for 1987. We are very pleased to have as our witness the Honorable James A. Baker III, Secretary of the Treasury.

Yesterday the Economic Report of the President was presented to the Joint Economic Committee by the Council of Economic Advisers and its distinguished Chairman Beryl Sprinkel. Today we will focus particularly on one of the most pressing set of problems raised in the Report, the unprecedented U.S. trade deficit and the strains and uncertainties in international economic relations.

For most of this country's history, the U.S. economy has been remarkably self-sufficient. Until recently, only 5 percent of our GNP was involved in world trade, and U.S. exports consistently exceeded imports. The period of U.S. reliance on foreign capital to finance industry lies beyond the reach of modern American memory. Since World War I, the United States has been a creditor nation, in fact the world's largest creditor nation. In the period following World War II, the United States was in a position to oversee the creation of an orderly international monetary system and to underwrite the reconstruction of the economies of Western Europe and Japan. We did it under the well-founded assumption that the rest of the world as well as the United States would benefit from a vigorous international economy.

What could not be foreseen was that major trading partners would also become major trading competitors. Nor was it possible to foresee that many nations whose economies were insignificant then would become vigorous participants in all aspects of international economic activity.

Today the American economy is far more integrated into the world economy. In 1986, imports came to 14.2 percent of our GNP, triple the level of the 1950's. Our merchandise trade balance has plunged into deficit, with the United States importing $175 billion more last year than we exported. As a result, in the brief two-year period from 1984 to 1986, the United States became a debtor nation for the first time since World War I.

The harm done to the economy by the trade deficit is a cause for serious concern. In expressing his willingness Tuesday night to work with Congress on a trade bill to improve U.S. competitiveness and to open foreign markets to American-made goods, the President acknowledged as much. Until recently, the Administration has appeared to take the grave deficit situation in stride. The President's comments in his speech Tuesday night, together with recent steps taken by the Secretary of the Treasury, our witness today, suggest a more constructive reappraisal of what can only be described as an urgent problem.

The solution will be complex, requiring responsible and effective measures to reduce the Federal deficit and prudent steps in the realm of international economic policy.

We look forward to discussing these issues this morning as well as important domestic economic policy issues. We are very pleased to welcome as our witness the distinguished Secretary of the Treasury, James A. Baker III.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative **Wylie**. I'm going to make my opening statement brief.

I do want to express my pleasure and join with you, Mr. Chairman, in welcoming our distinguished witness today, Secretary of the Treasury James Baker, and I want to compliment him for being a part of much of the economic progress that has been made in recent years as the point man for the administration and for the work that he has done with Chairman Volcker of the Federal Reserve in this regard.

I would also like to commend the Secretary for his work on the historic Tax Reform Act of 1986. Those who are filling out the W-4's are questioning whether it was a good thing or not, but I think in the overall it will be, and I think that it helped our economic recovery in that it sharply reduced the marginal tax rates and I think Secretary Baker and the administration has created a foundation for a strong economic growth period in the coming years and I, too, want to join you and say thank you very much, Mr. Secretary, for being here this morning.

Senator **Sarbanes**. Thank you, Congressman Wylie.

Without objection, I hereby ask that the record include Senator D'Amato's written opening statement at this point. He is unable to attend today's hearing due to another commitment.

[The written opening statement of Senator D'Amato follows:]

WRITTEN OPENING STATEMENT OF SENATOR D'AMATO

MR. CHAIRMAN, I WANT TO WELCOME TO THE JOINT ECONOMIC COMMITTEE THIS MORNING OUR DISTINGUISHED SECRETARY OF THE TREASURY, JAMES A. BAKER III. I LOOK FORWARD TO YOUR COMMENTS ON THE ECONOMIC OUTLOOK AND THE ADMINISTRATION'S ECONOMIC POLICIES FOR 1987.

WE ARE CURRENTLY ENJOYING OUR FIFTH CONSECUTIVE YEAR OF OF ECONOMIC EXPANSION. MANY ECONOMISTS ARE PREDICTING THAT THE GROWTH RATE FOR THE GROSS NATIONAL PRODUCT, ADJUSTED FOR INFLATION, SHOULD ACCELERATE TO 3.2 PERCENT IN 1987. THE ADMINISTRATION'S EFFORTS NOT TO RAISE TAXES WHILE AT THE SAME TIME KEEPING INFLATION LOW, HAS CREATED A REMARKABLE CLIMATE FOR INVESTING IN THE FINANCIAL MARKETS. INVESTORS AND CONSUMERS ALIKE HAVE BENEFITTED FROM THE NUMEROUS RECORD-SETTING DAYS ON WALL STREET.

WHILE THE FINANCIAL MARKETS ARE BULLISH, AND THE DOLLAR CONTINUES ON ITS PRESENT DOWNWARD TREND, NOW IS THE TIME TO FOCUS ON THE SAVINGS AND INVESTMENT BALANCE IN THE UNITED STATES. THIS CRUCIAL BALANCE IS WHAT MUST BE EFFECTED IN

ORDER TO REDUCE OUR SPIRALING TRADE DEFICIT. THIS BALANCE IS DIRECTLY RELATED TO ANY FLUCTUATIONS IN THE DOLLAR. THE MORE THE DOLLAR FALLS, THE BETTER THE MARKET FOR U.S. EXPORTS. IF THIS TREND CONTINUES, IT WILL EVENTUALLY RESULT IN A VAST REDUCTION OF OUR TRADE DEFICIT. WHILE THIS IS BENEFICIAL TO OUR INTERESTS, THE DROPPING DOLLAR HAS CREATED ANXIETY AMONG MANY OF OUR TRADING PARTNERS.

I LOOK FORWARD TO THE COMMENTS OF OUR DISTINGUISHED WITNESS, AND HOPE THAT HE CAN PROVIDE SOME INSIGHT INTO THE LONG AND SHORT TERM IMPLICATIONS TO THE FALLING DOLLAR. ITS EFFECT UPON THE ESCALATING FEDERAL BUDGET AND TRADE DEFICITS PLAY A CRUCIAL ROLE IN OUR ECONOMIC OUTLOOK FOR THE COMING YEAR.

THANK YOU, MR. CHAIRMAN.

Senator **Sarbanes**. Mr. Secretary, we are prepared to hear from you.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY OF THE TREASURY

Secretary **Baker**. Thank you, Mr. Chairman, and thank you, Congressman Wylie. I am pleased to be here this morning and if it's all right, Mr. Chairman, I would like to ask that my prepared testimony be submitted for the record and I will briefly summarize it.

Senator **Sarbanes**. Fine. The full statement will be included in the record.

Secretary **Baker**. Mr. Chairman, I would like to start by pointing out, as I have before the House and Senate Budget Committees, that during 1986 the United States took two historic steps that hold the promise of improving our economic performance for some years to come.

Congressman Wylie mentioned one of these—the forces set in motion by the President in his State of the Union address of 3 years ago culminated in the Congress' enactment last summer of a comprehensive reform of our tax system. This bipartisan effort created a fairer, more equitable tax system, one containing major incentives for increased economic progress in this country.

Second, the Tokyo Economic Summit laid the foundation for sustained world economic growth by starting to provide procedures for improved coordination of economic policies among the seven leading industrial economies.

While the art of international economic cooperation is still developing, our preliminary successes have created an environment of opportunity which I hope we can take advantage of.

The record for the year 1986 was generally favorable, though we aspire for continued improvement. Let me briefly sum up.

The current expansion has extended into its fifth year. We are in the 50th successive month of sustained economic expansion and I think there's every prospect that this expansion will continue unabated through 1987 and into the years beyond. I might point out that only twice before, since World War II, Mr. Chairman, have we seen an expansion of this duration.

In 1986, consumer prices increased 1.1 percent, less than any year in more than two decades. Over the past 6 years inflation has been cut drastically from the nearly 13 percent average in 1979 and 1980 to 4 percent or less for the last 5 years.

The number of people holding jobs increased by 2.5 million during this year alone and throughout the present expansion the number of jobholders has risen by more than 11.5 million, lifting the percentage of the civilian population employed in the United States to a record level of 60.9 percent.

Interest rates continued to decline. The prime rate now is down 2 full percentage points from early January 1986, and it's down two-thirds of what it was in 1981. At 7.5 percent, it's the lowest it has been in more than 9 years.

So, Mr. Chairman, I would submit to you that this is solid economic performance, but at the same time I would recognize that we still have a lot of work to do. The progress of 1986 should set the stage for an even better year for real economic growth and employment in 1987.

To summarize our economic forecast, we expect real growth to average 3.25 percent across the four quarters of this year and this estimate is roughly in line with the private forecasters' consensus of growth slightly below 3 percent. It's a little faster than the roughly 2¼ percent averaged during the four quarters of 1986, but signs were emerging in the latter part of last year that the economy may be gaining some momentum.

We cannot expect inflation to remain as moderate in 1987 as in 1986, which, of course, benefited from the fall in world oil prices. Still, no resurgence of that inflation, in our view, is in prospect and we expect the GNP deflator to increase by about 3.5 percent during the year with consumer prices rising by a shade more than that.

Development in the world economy should also help further our objectives in 1987. We have been working closely with the leadership of the major industrialized nations to improve economic policy coordination and global prospects for sustained, noninflationary growth worldwide.

The experience of recent years has brought home to all of us here today just how interdependent the world economy has become. The effect on large segments of U.S. industry of deteriorating U.S. trading accounts has been painfully clear in this country. During the past year we've made progress in establishing the fundamental conditions for balanced global growth and for a reduction in external imbalances.

The dollar has now depreciated substantially vis-a-vis the currencies of the other major industrial countries since its peak in February 1985; two-thirds of the adjustment occurred since the Plaza agreement of September 1985.

The industrial countries have sustained moderate growth while the nonoil exporting developing countries grew fairly strongly over the past year.

In this environment, many observers believe that external imbalances among the major industrial countries may have peaked last year.

Our challenge now is to reduce the external imbalances even further. The exchange markets are telling us that additional action to bring down the U.S. trade deficit is needed. Exchange rates play an important role in the adjustment process, but as we've said for some time, they cannot and should not be the sole mechanism. You cannot reduce the external imbalances using the exchange rate alone.

If the costs of adjustment abroad are to be held to the minimum, exchange rate changes must be complemented by stronger growth abroad and by measures to adjust the structures of our economies. We will continue to impress upon other industrial countries, particularly those with large external surpluses, our mutual need for them to achieve stronger, sustained growth. Because it is clearly time for our exporters to benefit from a greater growth abroad and a more reasonably valued dollar we could not pick a worse time to unfurl a banner of protectionism here in the United States.

Our program for sustained growth for the heavily indebted developing countries is coming into place and enhancing prospects of renewed growth and development in these countries. The debt problems of these developing countries didn't arise overnight and they won't be solved overnight, but the combination of market oriented reforms, structural lending from the multilateral institutions, and commercial bank loans to help implement comprehensive adjustment is making a very good start.

Over the last 6 years we have come a long way in the economic area. Still, there is a major item of unfinished business on the fiscal agenda as we all know—further reduction of our Federal budget deficit. If the budget just submitted by the President were to be adopted, the deficit would shrink substantially for the second consecutive year and would drop to about 2.3 percent of GNP in fiscal year 1988. The deficit, in our view, should be cut by reducing the scope of government rather than through tax rate increases. The American people, Mr. Chairman, in our view, are not undertaxed.

We have approached deficit reduction somewhat differently this year. Some have suggested that our budget is a carbon copy of previous budgets and I think nothing could be further from the truth. There's less reliance on programmatic reductions in this budget and we are not relying as heavily on spending cuts previously submitted and rejected by the Congress.

We are proposing $18.7 billion in deficit reduction on the spending side in fiscal 1988. However, we are also recommending $22.4 billion in deficit reduction in fiscal 1988 through changes affecting receipts. Over half this amount involves temporary measures that do not represent a permanent revenue stream which would encourage growth of the Federal Establishment. And while the remainder of the receipt changes do represent permanent revenue proposals, they have to do with initiatives to collect taxes owed or to collect fees for services rendered.

These revenue measures should be distinguished from a general tax increase that could be used to support additional spending.

Let me comment on one final area. There is a growing recognition that the United States faces new competitive challenges in the world economy. We must meet these challenges to maintain our economic strength and to maintain our world leadership.

One attribute that has made the U.S. economy a world leader is its flexibility. Shifts in job growth from one sector to another are examples of this flexibility. Many jobs in the service sector, for example, are technically advanced, dealing with communications, information management, teaching, health care, and other positions on the forefront of our economic development.

One of the most rapidly growing segments is business services whose jobs have increased three times faster than the entire service sector since the recession ended in November 1982.

So we need to keep in mind our comparative advantage for the 21st century. While we will continue to support reasonable efforts to ease hardship caused by dislocation of workers, it would be a grave mistake to try to protect some older industrial sectors at the expense of consumer and emerging sectors. If America is to lead in the future, we must not be afraid of it.

There are several ways the Federal Government in the context of a free market and limited public involvement could increase productivity and promote more efficient use of resources. We should defend intellectual property rights at home and in international negotiations and we should remove legal barriers to the international competitiveness of U.S. industries in the areas of antitrust and product liability.

In addition, the administration's budget seeks to strengthen certain leading edge technologies by fostering the commercial development of space and strengthening military programs involving strategic computing and very high speed integrated circuits.

Efforts to promote human capital development are also important for improving productivity and competitiveness. Accordingly, the budget includes funds to expand and improve training and job placement assistance for workers dislocated due to imports or due to other developments as well.

Mr. Chairman, this budget can help prepare America for the future while moving us well along the deficit reduction path. I am quick to recognize that any venture involving budget cutting will breed disagreements, some of which are very strongly held, but we have to keep at it. Now that we've turned the corner, we really shouldn't slacken up.

The Congress has made some very difficult decisions on expenditure cuts over these past years. The administration recognizes and applauds those members of both parties who have acted courageously to better serve the Nation's interests. We are hopeful that their leadership will carry forward the momentum of deficit reduction.

[The prepared statement of Secretary Baker follows:]

PREPARED STATEMENT OF HON. JAMES A. BAKER III

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today to discuss the state of the economy, international economic affairs, the Administration's Budget, and our proposals for deficit reduction.

1986 in Review

During 1986, the United States Government took two historic steps that hold the promise of improving American economic performance for years to come.

First, the forces set in motion by the President in his State of the Union Address of three years ago culminated in Congress' enactment last summer of a comprehensive reform of our tax system. This bipartisan effort created a fairer, more equitable tax system -- one which enhances economic efficiency and strengthens incentives for increased economic progress. Tax reform should remove about 6 million Americans from our income tax rolls. It slashes the top statutory individual tax rate to less than half the top rate when President Reagan took office. And it focuses capital on productive uses, not tax uses.

Second, the Tokyo Summit laid the foundation for sustained world economic growth by starting to provide procedures for improved coordination of economic policies among the seven leading industrial democracies. While the art of international economic cooperation is still developing, our preliminary successes have created an environment of opportunity.

The record for the year 1986 was generally favorable -- though we aspire for continued improvement. To summarize briefly:

- The current expansion has extended into its fifth year, exceeding in duration 5 of the previous 7 expansions. There is every prospect that the current expansion will continue unabated through 1987 and the years beyond. Despite the longevity of this expansion, it has led to few if any of the imbalances that marked the latter stages of previous cyclical expansions.

- The increase in consumer prices during 1986 was less than in any year in more than two decades. For the millions of elderly Americans who fear the erosion of hard-earned savings from inflation, this affirmation of our earlier accomplishment is most welcome. Over the past six years, inflation has been cut drastically from the nearly 13 percent averaged in 1979 and 1980 to 4 percent or less for the last five years.

- The number of persons holding jobs increased by 2-1/2 million during the year. Throughout the present expansion the number of jobholders has risen by more than 11-1/2 million -- lifting the percentage employed of the civilian population to the record level of 60.9 percent.

- Interest rates continued to decline. The prime rate is down 2 full percentage points from early January 1986 (down two-thirds of what it was in early 1981), and at 7-1/2 percent is the lowest in more than nine years. Other rates, both short- and long-term, are down about 1-1/2 percentage points from a year ago. This has been particularly good news for young people striving to buy their first homes or refinancing high rate mortgages. Policies of the Federal Reserve assured that ample credit was available.

I would submit to you that this is a solid economic performance. Nevertheless, we still have much work to do. The progress of 1986 should set the stage for an even better year for real economic growth and employment in 1987.

1987 Forecast

To summarize our economic forecast, we expect real growth to average 3-1/4 percent across the four quarters of this year. This estimate is about in line with the private forecasters' consensus of growth slightly below 3 percent. It is a little faster than the roughly 2-1/4 percent averaged during the four quarters of 1986, but signs were emerging in the latter part of last year that the economy may be gaining momentum.

We cannot expect inflation to remain quite so moderate in 1987 as in 1986, which benefited from the fall in world oil prices. Still, no resurgence of inflation is in prospect, and we expect the GNP deflator to increase by about 3-1/2 percent across the four quarters of the year, with consumer prices rising by a shade more than that.

For the longer term, it is reasonable to expect the economy to grow at least a little above trend until a fuller rate of resource utilization has been reached, and that is incorporated into our forecast. Our longer-term forecast also envisions that we will maintain and improve upon our progress in bringing down the rate of inflation.

The International Economy

Experience of recent years has brought home to all of us here today just how interdependent the world economy has become. The effect on large segments of U.S. industry of deteriorating U.S. trading accounts has been painfully clear in this country. At the same time, our efforts to contain inflation have been aided importantly at various junctures by an appreciating dollar and declining international commodity prices. Nor can we overlook the role that capital inflows from abroad have played in supporting our own economic expansion.

The large U.S. trade deficit reflects the myriad linkages between our economy and the rest of the world. Exchange rate changes, the strong pace of U.S. economic growth relative to that of other major industrial countries, and the debt problems of the developing countries all have influenced our trade deficit. Our future performance on these counts will determine in large part our success in reducing that deficit.

During the past year, we have made progress in establishing the fundamental conditions for balanced global growth and a reduction in external imbalances. The dollar has now depreciated substantially vis-a-vis the currencies of the other major industrial countries since its February 1985 peak; two-thirds of the adjustment occurred since the Plaza Agreement of September, 1985. The dollar has declined 40-50 percent against the yen and the deutschemark since its early 1985 peak. Moderate growth has been sustained in the industrial countries, and the nonoil exporting developing countries over the past year have turned in a fairly strong growth performance. Rates of inflation in the industrial countries have, with an assist from the decline in oil prices, fallen to the lowest levels since the 1960s. Key interest rates have continued to trend down. Progress has also been made in reducing fiscal deficits in the major industrial countries to more manageable levels.

In this environment, many observers believe external imbalances among the major industrial countries may have peaked last year. The U.S. current account deficit probably reached about $145 billion in 1986, while the current surpluses of Japan and Germany, according to estimates of the Organization for Economic Cooperation and Development, will probably turn out to have been around $82 billion and $32 billion, respectively. Many forecasters think it likely that our current account deficit will decline this year to around $130 billion. The OECD projects the Japanese and German surpluses will decline moderately.

The exchange rate changes of the past two years have contributed to the steadying of our international trade balance, evident at times in the second half of last year. Obviously, we saw an unusually high trade deficit in November. We suspect that special factors -- such as accelerated imports in anticipation of the new tax law -- may be behind the November figures. In any case, we remain confident that the exchange rate changes that have taken place will contribute significantly to an improvement in our trade balance this year.

The challenge before us is to build on this foundation to achieve substantial further reductions in external imbalances. Exchange rates play an important role in the adjustment process, but they cannot and should not be the sole mechanism. If the costs of adjustment are to be held to the minimum, exchange rate changes must be complemented by stronger growth abroad and measures to adjust the structures of our economies.

We have sought to facilitate other necessary corrections of external imbalances through intensified international economic policy coordination. Over the past year, we concentrated considerable attention on strengthening international arrangements for such coordination. Building on the Plaza Agreement of September 1985, we were able to reach agreement on enhanced coordination at the Tokyo summit last May. The first meeting to implement the new process was held last September immediately prior to the annual meetings of the International Monetary Fund and the World Bank. In late October, the United States and Japan announced bilateral agreement on cooperative actions which, as they are implemented, will contribute to sustained growth in the world economy. On several occasions last year, internationally coordinated interest rate reductions took place. We will be building on these accomplishments in the year ahead, recognizing that each meeting will not produce an agreement and each agreement may not result in a major redirection of economic trends.

The pace and pattern of growth in the industrialized countries will continue to receive our close attention. Last year, domestic sources of demand growth strengthened abroad, particularly in Europe. Yet there can be little question that more needs to be done to promote more rapid growth abroad. As external surpluses are reduced, accelerated growth of domestic activity abroad is necessary to maintain even moderate rates of GNP growth.

We will continue to impress upon other industrial countries, particularly those with large external surpluses, our mutual need for them to achieve stronger, sustained growth. The alternatives to stronger growth abroad -- unacceptable levels of economic activity in the United States, or exchange rate changes greater than would otherwise be needed, or both -- cannot be viewed lightly in the current international environment.

Responsibility for actions contributing to the adjustment of our major external imbalances does not rest with the major industrial countries alone. The newly industrialized countries in Asia have also come to play a major role in international trading patterns. Open markets contributed much to the development of these economies, and many of the NICs are now ready to be brought into the world trading system as full-fledged participants. One essential element will be that they follow policies that allow their currencies to better reflect economic fundamentals. And they must open their markets to both foreign trade and investment.

As part of our international trade strategy, our GATT negotiators will press ahead with the Uruguay round, including updated rules to encompass agriculture, services, investment, and intellectual property rights. We are pursuing key bilateral talks with Japan in the MOSS negotiations and with Canada in the free trade area negotiations.

The Administration will also continue to attack aggressively unfair trade practices of our trading partners. President Reagan is the first President to initiate Section 301 cases. Our active enforcement has produced results with a number of countries.

While pursuing our efforts internationally, we must also move ahead domestically to strengthen our international competitiveness. There is growing recognition that the United States faces new competitive challenges as a result of fundamental changes in the world economy. The United States must meet these competitive challenges to maintain its economic strength and world leadership. We will work with the new leaders in Congress to produce responsible legislation to enhance America's competitiveness and to avoid the backward-looking protectionist response.

It is clearly time for our exporters to benefit from greater growth abroad and a more reasonably valued dollar. If they are to have access to markets abroad, however, we must maintain the openness of our own market. We could not pick a worse time than the present to unfurl the banner of protectionism.

International Debt

This Committee is well aware of the myriad linkages between debt and trade, as well as their common connection to global growth and financial stability. We all have a stake in constructively addressing international debt difficulties -- not via quick-fix gimmicks, but through lasting solutions to underlying problems.

I recognize that it is politically tempting to search for dramatic gestures which could sharply reduce debt service burdens overnight, or significantly increase the financial resources available to debtor nations to import our goods. Across-the-board debt forgiveness, in this light, may have some mistaken appeal, but would ultimately damage both debtor nations and the global economy. External capital would be available to debtors at prohibitive prices, if at all; bank losses would weaken some of our important financial institutions; and U.S. budget and taxpayer costs would increase significantly.

Similarly, calling for massive new lending (by others) to the debtor nations, either bilaterally or through a new multilateral fund, may appear to offer an easy way to boost U.S. exports and growth in the debtor nations. But without fundamental policy reforms, neither U.S. exports nor debtor growth can be sustained for the longer term. Throwing money at the debtor nations won't solve their problems; it will, in fact, worsen their difficulties unless the new financing can be productively absorbed and is consistent with their ability to grow and service debt.

In contrast to these "overnight" solutions, our debt strategy focuses on improving the debtors' growth potential through both macroeconomic and structural reforms, supported by modest new financing essential to meet immediate needs. Despite the relatively short period which has passed since we proposed this debt initiative, considerable progress has been made.

- Many debtors are already taking important steps toward increasing savings and investment, improving their economic efficiency, privatizing public enterprises, and encouraging the return of flight capital.

- The IMF has negotiated new standby programs with 8 of the 15 major debtors since October 1985, including new loan commitments of about $4.7 billion.

- The World Bank has negotiated $2.9 billion in new policy-based loans with 10 major debtors, and has discussions underway on nearly $5 billion in additional policy-based loans. Aggregate World Bank loan commitments to these debtors increased by 40 percent during its Fiscal Year 1986, and a substantially larger share of loans are now based on structural policy reforms.

- Finally, the commercial banks are also moving to make new loans available, as exemplified by the recent $7.7 billion package for Mexico, a $320 million new money package for Nigeria, and a $220 million oil facility for Ecuador. Nearly $70 billion in debt reschedulings have been negotiated with the major debtors since October 1985. A number of other financing packages and reschedulings are also now under discussion.

Externally, interest rates have been reduced by nearly 5 percentage points since 1984, saving the major debtors over $13 billion in interest payments annually. Efforts are underway to achieve stronger growth in other industrial nations, and to open global markets through the new multilateral trade negotiations.

This is a start -- a good one. We hope for further progress, but realistically must recognize that it will be gradual and will vary among nations, depending upon their own determination to implement growth-oriented reforms and the continued active support of the international community. That is the task before us, and the only true solution to international debt problems.

The MDBs are a particularly important vehicle for promoting growth-oriented reforms and for furthering U.S. foreign policy objectives. We, and other member countries, have succeeded in persuading the MDBs to advocate financing in support of difficult, but much-needed structural and sectoral growth-oriented reforms which are a central element of the debt strategy.

We also have succeeded in convincing other donor countries to increase their support of the MDBs. For instance, the Japanese increased their contribution to the eighth replenishment of IDA by $450 million to bring their share to almost 21 percent of the total, and the United Kingdom, the West Germans and other European countries also made additional special contributions to IDA. In total these increased contributions result in an IDA VIII of nearly $12.4 billion and a U.S. share of 23 percent, 2 percent less than the 25 percent U.S. share negotiated for IDA VII.

The United States clearly has significant influence in the MDBs. However, U.S. influence will diminish if we are not able to fulfill our commitments to these institutions. Consequently, it is essential that Congress support the Administration's FY 1987 supplemental request of $293 million and our FY 1988 request of $1.8 billion.

In a period of tight budgets, the cost effectiveness of the MDBs offers another reason for support: one dollar of U.S. budgetary authority for the World Bank translates into $60 of World Bank lending authority. About 90 percent of MDB lending supports countries of importance to the United States, some of which receive little or no U.S. foreign assistance, such as Mexico and Argentina.

Budget and Deficit Overview

We have come a long way over the past six years. Still, there is a major item of unfinished business on the fiscal agenda -- further reduction of the Federal budget deficit.

We have reached a turning point on the deficit. Measures already taken have pointed us in the direction of reduced deficits through spending restraint. Even if one assumes pessimistic economic forecasts, we already have put in place reforms that should lower the 1986 Fiscal Year deficit of $221 billion to roughly $175 billion in Fiscal Year 1987 on a current services basis -- from 5.3 percent of GNP to 3.9 percent -- with further reductions in later years.

Even this substantial reduction can and should be improved upon. The President's Budget provides a plan for further substantial progress. If the proposals in the Budget are adopted, the deficit would shrink substantially for the second consecutive year and would drop to about 2.3 percent of GNP in Fiscal Year 1988. When it passed the Gramm-Rudman-Hollings Act, the Congress set a deficit target of $108 billion for Fiscal Year 1988. We are submitting a budget that hits this target without raising taxes.

The deficit should be reduced by reducing the scope of government, rather than through tax rate increase. The American people are not undertaxed. As shown by the first chart attached to my statement, revenues as a share of GNP projected over the next six years are about one full percentage point above the historical average for the period 1964 to 1979. In contrast, the outlay share of GNP in the past two fiscal years was about four percentage points above the historical average.

Our budget cuts the growth in spending. Outlays will continue to grow in absolute terms along the path projected in the new budget, but the rate of advance will be reduced significantly. Between FY 1986 and FY 1992, nominal Federal outlays would rise on average about 3 percent per year. In the prior six-year period, 1980-1986, the rate of growth was about 9 percent per year. Along the path projected in the new budget, Federal outlays would decline steadily as a ratio to GNP from just under 24 percent in 1986 to just over 19 percent in 1992.

Receipts will be growing strongly in absolute terms as the economy itself grows, and as previously scheduled payroll tax increases become effective in 1988 and 1990. Receipts are projected to rise by an average of 7.6 percent annually between FY 1986 and FY 1992, slightly above the 6.8 percent rise averaged in the previous six-year period. Receipts as a share of GNP will rise from 18.5 percent in 1986 to 19.4 percent in 1991 and 1992.

A number of other turning points are projected in the FY 1988 Budget. These turning points are important for the stability of the credit markets and continuation of low interest rates and economic expansion. As the second attached chart shows, beginning in FY 1987, interest payments on the debt will be falling as a share of the budget, permitting faster growth in other outlay categories. As the third attached chart shows, by FY 1988, the economy will be growing faster than the national debt. By FY 1990, the national debt will be rising less rapidly than the rate of inflation, and will actually be falling in real terms.

Fundamental to good governance is the ability to set priorities. This budget shows that eliminating the deficit is possible without raising taxes, without sacrificing our defense preparedness, and without cutting into the safety net for the poor and elderly.

Other programs basic to our national interest also should be properly funded. Some -- like basic scientific research and the space program -- will help keep America strong as we prepare for the 21st Century. Others -- like drug enforcement, AIDS research, and reduction of infant mortality -- will safeguard the soul of America, her people.

Approach to Deficit Reduction

We have approached deficit reduction somewhat differently this year. There is less reliance on programmatic reductions, and we are not relying substantially on spending cuts previously submitted and rejected by Congress. We are proposing $18.7 billion in deficit reduction through cuts in programmatic spending in FY 1988. This is consistent with our goal of a permanently lower level of Federal spending, gradually arrived at.

We are also recommending $22.4 billion in deficit reduction in FY 1988 through changes affecting receipts. Of this amount, about $13 billion represents proceeds from loan asset sales, privatization efforts, credit reform and proposals to strengthen the FSLIC. These proposals provide a variety of near term budget savings over the next few years. Unlike new taxes, these proposals do not represent a permanent revenue stream which would encourage growth of government and a larger Federal establishment. Indeed, they work in the opposite direction.

The asset sales and privatization initiatives are one-shot final sales of portfolios and assets which are better managed and better run by the private sector. Sale of these assets will reduce the intrusion of the Federal Government into the economy. (Of course, there will be ongoing tax revenues received from profitable privatized enterprises.) Credit reform, while a permanent program, would act to reveal unintended subsidies and de facto "grants" on questionable or defaulted loans. While saving money near term, it would act to slow the growth of such programs and reduce government involvement in credit allocation decisions better left to the market. FSLIC recapitalization mobilizes the future insurance fees charged to the S&L industry to hasten the resolution of problems facing a portion of the industry, saving money long term and speeding the day when FSLIC intervention will return to more normal levels.

While the remainder of the receipts changes do represent permanent revenue proposals, they have to do with equity or fees for services, which must be distinguished from a general tax increase. For example, the IRS initiative seeks to improve on the collection of taxes owed but not paid. The extension of the medicare HI tax to state and local workers will cover a group whose members often become eligible for medicare services as spouses of eligible retirees or through periods of covered earnings in other occupations. Customs user fees are obviously fees for service.

The reduced level of debt brought about by these programmatic and receipts proposals will result in a reduction in interest outlays of $1.3 billion in FY 1988, in addition to the savings listed above.

In brief, we feel that these proposals are an innovative solution to the problem of reducing the deficit without expanding the government, and that they enhance both equity and economic efficiency at the same time. They offer added budget savings in the short term to achieve the desired degree of deficit reduction while enabling us to approach longer term programmatic savings in a more orderly and gradual fashion. This will make it easier ultimately to accomplish more in the way of permanent deficit reduction via reduction in the size of government.

Restructuring of the U.S. Economy

The United States has long been the world leader in industrial innovation. We have been the nation to whom others have looked for latest developments and emerging trends in the way business would be conducted worldwide. The speed with which American entrepreneurs could turn an idea into a product has been the envy of industrialized countries around the globe.

Recently, however, we have heard complaints that we are slipping. Difficulties in some manufacturing areas of the economy and the rise in the U.S. trade deficit have resulted in criticism that the United States was deindustrializing, that there were fundamental problems in the basic structure of our economy. Even the remarkable jobs growth that we have witnessed over the past four years has been devalued by those who consider the rise in service-sector employment as somehow inferior. Such critics say we are turning into a nation of short-order cooks and sales clerks.

Criticisms of certain aspects of the U.S. economy are justified and we should not fail to learn from them. There is no doubt that some industries let quality slip; wages got out of hand; management became bloated and inefficient. Fortunately, a free market fosters change, and we are beginning to see signs of a turnaround. There have been reports recently that quality shortcomings rapidly are evaporating as an issue in the auto industry and that some U.S. machinists are producing to zero defect standards. We do not intend to rest at a point when we are merely equal to others. We shall be working to achieve superior performance and international competitiveness in U.S. industry.

Among the misplaced criticisms of the American economy, however, is that the surge in jobs in the service sector is somehow bad. One of the attributes of the U.S. economy that has made it a world leader is its flexibility. It is able to adjust quickly to provide resources for emerging growth sectors. Shifts in job growth from one sector to another are examples of this flexibility.

Contrary to the impression one might gain from recent publicity surrounding the growth of the service sector, the trend toward a more service-oriented economy is not a new development, although there has been some slight acceleration recently. The share of nonfarm establishment employment taken by service-sector jobs grew from 59.1 percent in 1950 to 62.3 percent in 1960 and 66.7 percent in 1970. These represented gains of 3.2 percentage points in the Fifties and 4.4 percentage points in the Sixties -- periods in which no one complained of an erosion of our industrial base. There was a 4.9 percentage point rise from 1970 to 71.6 percent in 1980, and since then there has been a further 3.5 percent gain to a 75.1 percent share last year.

A drift toward services has prevailed throughout the post-World War II era and is no more wrong than the change toward a nonagricultural society in earlier decades. The gain in the service sector has been in part made possible by strong productivity growth in manufacturing industries, which has reduced the labor requirements of those industries. Indeed, manufacturing output as a share of real GNP has remained relatively constant on average during the post-World War II era.

The growth of the service sector has been tied to what some have claimed to be a deterioration of the United States' standing to that of a "low-wage economy." A recent JEC study made that point and decried the "growing income inequality" in this country. While we welcome efforts to understand developments in the U.S. economy, it must be recognized that there are many factors affecting income. Work by other researchers casts doubt on the influence of structural problems and suggests that other explanations such as experience, tenure, and baby boom effects may be playing more important roles in the incomes associated with job gains.

Certainly, researchers may differ. But in the interest of informed debate, I would like to note a few specific points about this recent JEC study.

o According to the Committee's own figures, the share of wage-earners in the low-wage stratum was 32.4 percent in 1984 -- an increase of 2 percentage points since 1979 and only 0.6 percentage point since 1973.

o Results are highly dependent on the price index chosen. Using the personal consumption deflator instead of the CPI (which has been criticized for exaggerating inflation prior to its reform in 1983), the share of low-wage jobs decreased from 1973 to 1984 and rose only 0.5 percent point from 1979 to 1984.

- Finally, the Committee's study counts as a "job" any individual aged 16 or over reporting wage and salary income during the sample year. This includes part-time workers and temporary workers such as college and high school students working in the summer. These persons' relatively low annual incomes are interpreted as low-wage jobs in the JEC study. Using year-round, full-time workers -- rather than all workers including temporaries and part-timers -- the number of workers in the low-wage stratum was only 6.0 percent in 1984.

Additionally, some people have serious misconceptions as to the nature of service-sector jobs. Last year less than 24 percent of service-producing jobs were in the relatively low-wage retailing industry. Many service jobs are technically advanced, dealing with communications, information management, teaching, health care, and other positions at the forefront of our economic development.

Some of these information-service jobs are critical to the support of our industrial base. One of the most rapidly growing segments of the service sector is business services (including computer and data processing), where jobs have increased over 50 percent since the recession trough, compared to a rise of only 16 percent for the entire service sector.

When people offer proposals to protect jobs in the traditional, manufacturing industries, we need to keep in mind our comparative advantage for the 21st Century. While we will continue to support reasonable efforts to ease hardship caused by dislocation of workers, it would be a grave mistake to try to protect some older industrial sectors at the expense of the consumer and new emerging sectors in both manufacturing and services. We can and will retain an efficient manufacturing sector, just as we shall have a farming sector that produces abundance. But it will not do either sector or our country as a whole any good to maintain sector-by-sector employment levels from days past through exorbitant subsidies or anti-competitive barriers. The United States economy must retain its flexibility if we are to become truly competitive. If America is to lead in the future, we must not be afraid of it.

American Competitiveness

There is growing recognition that the United States faces new competitive challenges as a result of fundamental changes in the world economy. Many countries have emphasized scientific progress, technology transfer and improved productivity growth to strengthen the international competitiveness of their economies. The United States must meet these competitive challenges to maintain its economic strength and world leadership.

Concern for global competitiveness does not necessarily imply that we should look at policies that will artificially promote certain industries or sectors to reduce specific portions of our trade deficit. Such an approach suggests an industrial policy that could emphasize some industries that do not have a comparative advantage in trade at the expense of those that do, and could impede the efficient allocation of our resources.

Rather, there are many areas where Federal Government actions, in the context of a free market and limited public involvement, could increase overall U.S. productivity and improve U.S. competitiveness by promoting more efficient use of resources. These include encouragement of research and development, defense of intellectual property rights at home and in international negotiations, promotion of human capital development, and removal of legal barriers to the international competitiveness of U.S. industry in the areas of antitrust and product liability. The Administration has already taken a number of steps in these areas. As the President discussed this week in the State of the Union Message, we have much more to do to enable Americans to reach this potential.

Toward that goal, we propose several programmatic increases in the FY 1988 Budget. These proposals include increased funding for Federally supported basic research. The Budget would increase funding about 18 percent for basic research for the National Science Foundation, and double its research budget over the next 5 years; increase funding about 22 percent for basic research by NASA, including two new science and technology programs; and increase funding about 15 percent for the general science programs of the Department of Energy.

Basic research on an interdisciplinary basis often leads to creation of important new fields, such as biotechnology. For 1988, the Administration proposes to establish 5 to 10 new interdisciplinary science and technology centers through the National Science Foundation, modeled after NSF's existing engineering research centers, with participation by industry and the states to speed transfer of new knowledge from the laboratory to the marketplace. In addition, we propose to increase the emphasis on academic basic research programs in order to enhance the development of the nation's scientific and engineering human capital.

A substantial amount of non-classified technology and new knowledge is developed in Federal laboratories. However, its usefulness is limited if it is not made available to the private sector where it can contribute to creation of new products, new processes, new jobs and enhanced U.S. competitiveness. Using the Technology Transfer Act of 1986 and other authority, the Administration will increase efforts to transfer to the private sector results of non-classified Federally supported research and development. Toward that end, we propose to employ greater use of incentives for Federal scientists and engineers, exchange of scientists and engineers between government laboratories and industry, and cooperative research projects between industry and Federal laboratories.

The Administration's Budget also seeks to strengthen certain "leading edge" technologies. We propose to: initiate a new civil space technology effort to deploy the space station, develop the national aerospace plane, and foster commercial development of space; strengthen the Strategic Defense Initiative and associated Department of Defense initiatives involving strategic computing and very high speed integrated circuits; and support cooperative research and development ventures by the Department of Energy to encourage greater private sector participation in fossil, solar, and energy conservation research and development.

Efforts to promote human capital development are also important for improving productivity and competitiveness. Accordingly, the Budget includes funds to expand and improve training and job placement assistance for workers dislocated due to imports or other developments.

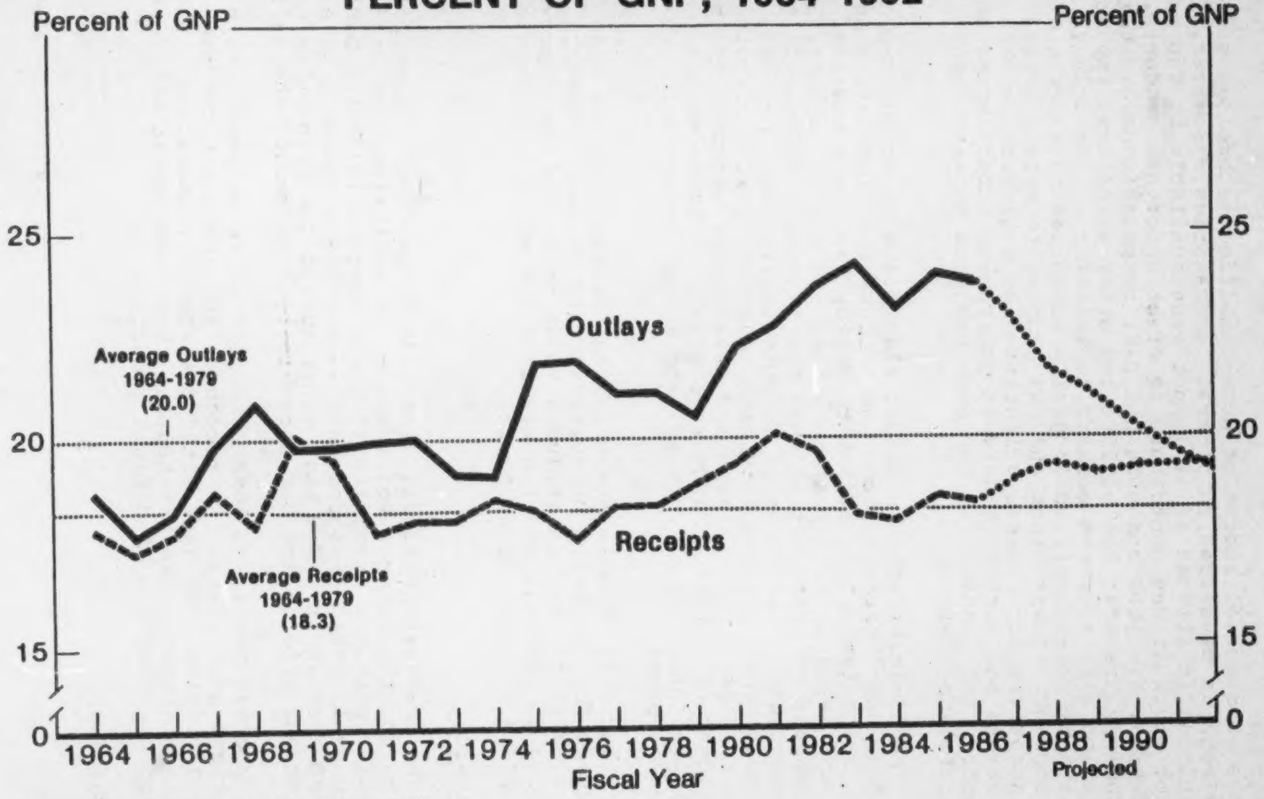
Conclusion

The President's Fiscal Year 1988 Budget can help prepare America for the future, while moving us well along the deficit reduction path. I recognize that any venture involving budget cutting will breed disagreements -- some very strongly held. But we must keep at it. Now that we've turned the corner, we can't slacken our efforts and our determination to reduce the deficit.

Congress has taken some difficult votes on expenditure cuts over these past years. We recognize and applaud those members, of both parties, who have acted courageously to better serve the nation's interest. We are hopeful their leadership will carry forward the momentum of deficit reduction.

Attachments

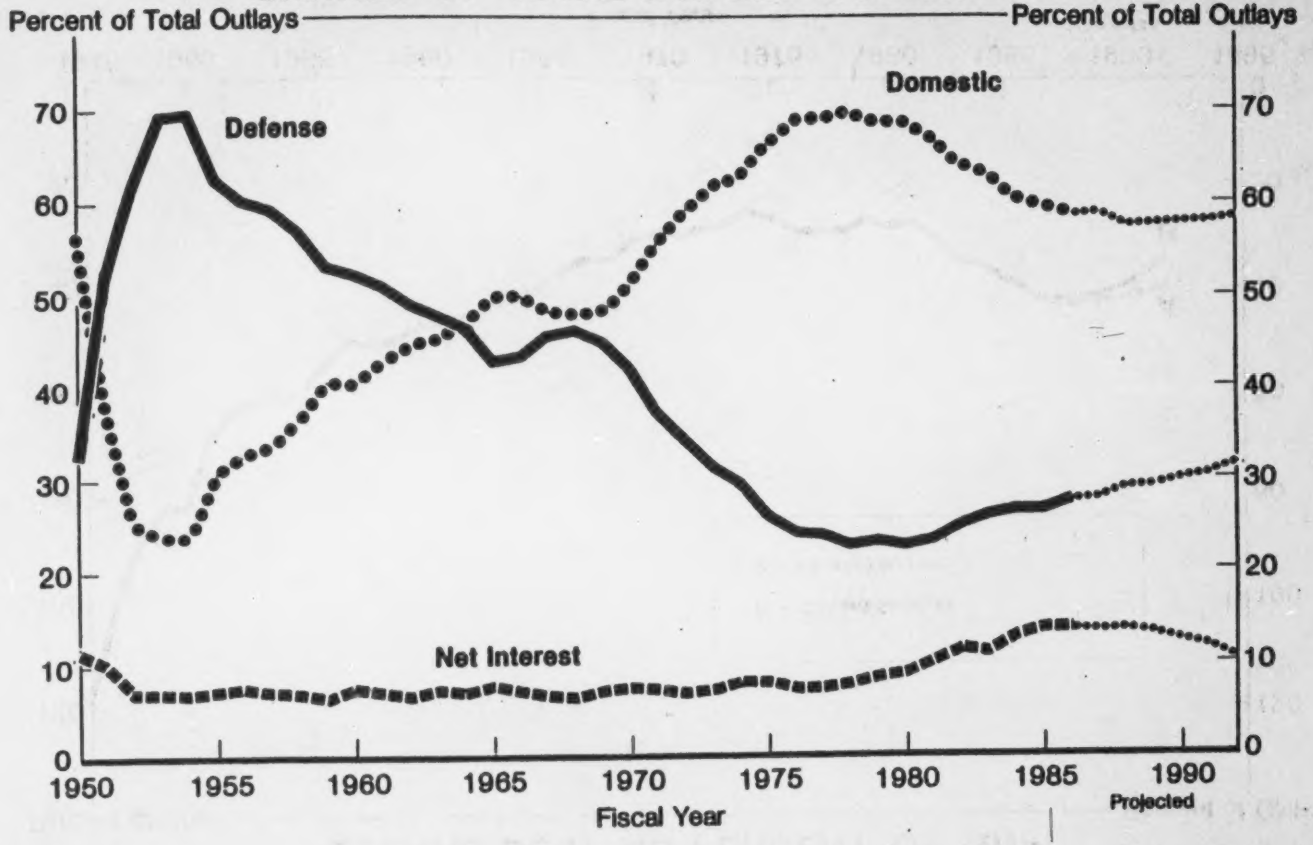
OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1992



Note: Outlays include off-budget federal entities.

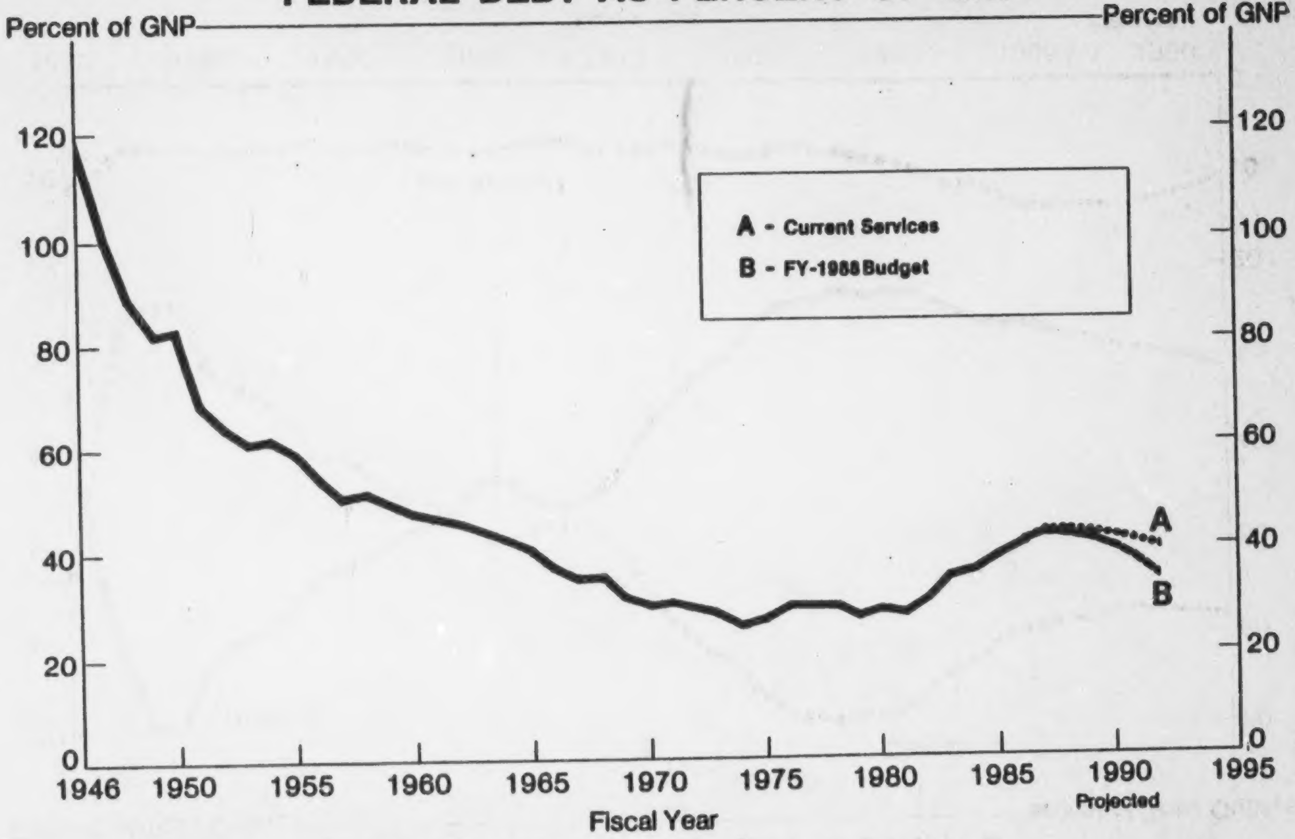
January 2, 1987-A54a

SHARES OF TOTAL BUDGET OUTLAYS



January 6, 1987-A303

FEDERAL DEBT AS PERCENT OF GNP



Note: Debt held by the public, including the Federal Reserve.

January 2, 1987-A82b

Senator **Sarbanes**. Thank you very much, Mr. Secretary.

I would say to the members of the committee that I think we will follow a generous 5-minute rule on the first round. Then we can come back for a second round.

Mr. Secretary, the New York Times yesterday reported that global currency trading was roiled by rumors that the Bank of Japan and the Federal Reserve had intervened heavily to support the dollar, and rumors that in the course of this trip you're making to Saudi Arabia there would be a G–5 meeting taking place somewhere in Europe.

Today the morning papers again are replete with these rumors. They are almost assuming the dimensions of sort of a mystery novel because they are now tracking the movements of Assistant Secretary Mulford, who's reported to be your planner for such meetings, and it's big news that administration sources said Mr. Baker's principal planner for such talks, Assistant Secretary David Mulford, left Washington Wednesday night or early today for an undisclosed location in Europe.

I think you ought to address these rumors in the course of this morning. First, I'll give you an open-ended question. I then have some specifics about it, but first I'd like to hear your response to these rumors. I don't see how you can really make effective policy in an atmosphere rife with such rumors and I think you ought to address them.

Secretary **Baker**. Mr. Chairman, I'm glad somebody is keeping track of the Assistant Secretary for International Affairs.

I cannot comment on intervention. We never do, as you know, and we should not. It would be bad policy in my view for the Treasury to comment on when it might or might not intervene or whether it has or has not intervened.

With respect to whether or not there is a G–5 or will be a G–5 meeting, I would only say that we stay in close contact with our major trading partners, both the nations of the Group of Five, as well as the nations of the Group of Seven, and as we sit here this morning, Mr. Chairman, there are no present plans for a G–5 meeting.

Senator **Sarbanes**. You said last weekend that the United States would take no action to stop the slide of the dollar. On the other hand, on one of Sunday's television shows you said that we do not want to see the dollar in a free fall and that a sharp drop would be counterproductive to achieve growth from our other trading partners.

What's your view on the current range in which the dollar finds itself, in terms of evaluation in the currency market?

Secretary **Baker**. Mr. Chairman, I don't remember speculating on whether we would or would not take action because that would be, once again, commenting on matters such as the possibility of intervention and I don't recall making any such statement.

With respect to my view on the dollar, let me try and articulate it as I did over the weekend. I think that what has happened to the dollar since the Plaza agreement has been beneficial and will prove to be beneficial insofar as the trade deficit of the United States is concerned, recognizing that there is a substantial lagtime between exchange rate changes and movement in the trade figures.

I also said that contrary to published reports the United States is not, and has not been for a period of a year, talking down the dollar. The last time we were talking down the dollar was when I testified at this time last year. If you will go back and check the record you will see that we have not said for over a year that we would not be displeased to see a further orderly gentle decline of the dollar. So I would like to put those rumors to rest.

Having said that the movement since the Plaza will prove to be beneficial, I would like to also say that we do not favor instability in the exchange markets and there were periods of instability over the past couple of weeks.

I would also like to say that we recognize that there are two sides to this question of a decline of the dollar, and while it may be beneficial if it is accomplished in an orderly and moderate way, generally speaking, when a country's currency declines there is a risk that it will result in inflation. We haven't seen that, Mr. Chairman, in the United States and we have been extraordinarily fortunate, in my view, that the decline of the dollar has been accomplished at a time when oil prices were coming down worldwide.

There is one further problem with a too rapid or too great a fall of the dollar; we might find that we would have to pay higher rates of interest to finance our debt. I might also say to you that so far we have seen no discernible effect in debt financing operations from the decline of the U.S. currency.

Senator **Sarbanes**. Well, one final question and then my time is up. There was an article recently entitled "Mr. Baker's Subtle Strategy of Coercion," which I'm sure you've seen. It said, "The dollar is his only weapon," and then went on to say, "There is considerable unease in the American financial community about Treasury Secretary James Baker's apparent decision to pursue an aggressive devaluation strategy against West Germany and Japan."

What is it that you seek West Germany and Japan to do, in terms of the economic policies they should pursue to help the international economic situation?

Secretary **Baker**. Mr. Chairman, we think that it is important if we are going to resolve these external imbalances between the major industrial nations of the world that these other countries with large surpluses do whatever they can to stimulate growth in their economies. I might add, consistent with retaining the gains that the world has made against inflation, we are not asking for any pump-priming measures or anything of that nature to help the United States carry the world economy.

We have been outgrowing these countries for the most part for the past 4 years during the course of our expansion. The United States, for instance, has picked up 60 percent of the increase in exports from lesser developed countries in recent years. All we are asking is that the other major industrial countries of the world do whatever they can, both fiscal and monetary, to permit their economies to grow as much as they can consistent with the gains that the world has made against inflation.

Senator **Sarbanes**. I'll turn to Congressman Wylie. On my second round I want to try to expand on that. It seems to me it's also reasonable that they should seek to stimulate growth not only in their own economies but in the economies of developing countries in a way that would expand international trade generally and help to make the developing world again an engine of growth in the international environment.

Secretary **Baker**. I agree with that, Mr. Chairman.

Senator **Sarbanes**. Congressman Wylie.

Representative **Wylie**. Thank you, Mr. Chairman.

Secretary Baker, I would like to ask a question up front which I need to ask for my constituents who asked me to ask you if I had an opportunity, and this seems like a good time.

It has to do with the W-4 forms. I've been getting an earful from constituents about the W-4 form lately and a number of constituents and their Congressmen are unhappy about the complexity and lack of clarity.

Can you tell me whether Treasury has taken any steps to clarify or simplify or streamline the form? Should they go ahead and file the W-4 or will there be another version?

Secretary **Baker**. Congressman Wylie, the W-4 form was developed because the Department was under instructions from Congress to develop a form that would do a better job of predicting withholding for taxpayers and I suppose this form will do a better job than the old form.

However, it is very complicated, as you know from communications from your constituents.

Representative **Wylie**. And trying to fill one out.

Secretary **Baker**. It's very difficult. And we have asked, therefore, that it be reviewed and we are seeking to simplify it, but at the same time do it in a way that would make it more accurate in terms of the withholding information that would be furnished by individual taxpayers.

Pending this review, it's very important that taxpayers continue to fill out their W-4 forms because if they don't they may find down the line later this year that they have been underwithheld on and they may have a very, very unpleasant surprise, that being that they owe more taxes than they thought they would owe.

We are working very hard to see if we can come up with a form that will do the job that's a little bit easier to understand.

Representative **Wylie**. But for this year go ahead and fill out the new W-4 form and hope for better things next year?

Secretary **Baker**. Well, at least until we can come up with a better form and I'm not ruling out the possibility that we might be able to do that this year, but I can't tell you for sure that we will be able to. So we are encouraging taxpayers to go ahead and continue to fill out their W-4's and in the meanwhile we're going to do our very best to come up with a better form.

Representative **Wylie**. Thank you.

Have you seen the press release this morning from the Department of Commerce that has to do with the trade deficit for December?

Secretary **Baker**. Yes, sir.

Representative **Wylie**. That's pretty good news, isn't it?

Secretary **Baker**. It's very good news on a month-to-month basis, Congressman Wylie. But I really think that, notwithstanding the fact that we saw the December trade deficit drop from $19 billion in November to just $10½ billion in December, as I said earlier testifying about the November number, we ought not to put too much faith in these month-to-month estimates because they can be very, very unreliable. They are highly variable.

Clearly, we are pleased to see this result, but we ought not to put too much faith in that figure and I don't think that you can necessarily conclude from this that the trade deficit has started declining. You might be able to conclude that we finally leveled it off so that it's no longer increasing substantially. But the number is considerably better than most people were looking for.

Representative WYLIE. So you're cautioning us not to feel that that means a turnaround in the trade deficit?

Secretary BAKER. As I said about the $19 billion in November, I don't think 1 month necessarily is all that good an indicator of trend. I must say, had we had another $19 billion month in December, it would have been very disturbing.

Representative WYLIE. All right. Well, it seems to me that there is some reason for optimism there.

The trade deficit is expected to improve in 1987 according to Beryl Sprinkel, Chairman of the Council of Economic Advisers, who was here yesterday, but he cautioned that we had to do something about reducing the budget deficit, that we needed to improve spending restraints.

What do you feel is the problem as far as the fiscal deficit is concerned? What is the degree of relationship between the budget deficit and the trade balance deficit?

Secretary BAKER. Well, I think you could probably get economists to differ on that, Congressman Wylie, and Beryl Sprinkel, of course, is an economist and I'm not. Let me just say that I think there is some relationship between the fiscal deficit and the trade deficit.

I think it's extremely important, as I indicated in my oral statement, that we move as aggressively as we can on our fiscal deficit. It happens to be one of the measures that's included in the President's competitiveness package. We are not going to be able to become competitive in this country, regardless of what else we do, unless we make progress on our fiscal deficit.

So I would acknowledge that there is some relationship. I think it's an important relationship, but I couldn't quantify it for you.

Representative WYLIE. Thank you. My 5 minutes are up.

Senator SARBANES. Congressman Hawkins.

Representative HAWKINS. Mr. Secretary, my constituents are not worried about the tax form. They are making so little that they may not be concerned about what taxes they pay. What they're worried about is, they keep hearing individuals in Washington talk about recovery. They are still suffering from the 1981–82 recession.

It's true that inflation has come down, but it took two back-to-back recessions and a little help from OPEC to bring inflation down. But they're wondering when we will begin to talk not just about the things that are right—and certainly there are many things that are right about the economy and I think you certainly enumerated those strengths—however, there are many weaknesses, as I'm sure that you would acknowledge, and we don't seem to be addressing those.

The unemployment rate obviously is far too high. It's not even manageable. And that would not be as bad if it were not true that you're projecting for the next 5 or 6 years very little improvement in the official unemployment rate and then ignoring the real unemployment rate which is almost double the official rate.

You certainly have some reason or should have some reason to be concerned. A recent report of the Joint Economic Committee informs us that "of the 8 million news jobs created between 1979 and 1984, 60 percent are paying at the $7,000 a year wage level."

Now it's true that some jobs in high tech pay a lot more than that. You can say a few of them do, but the net increase has been at that low level and that is accelerating. And if we continue in that regard, then it simply means that purchasing power will certainly go down and aggregate demand will be much less and your optimism about the future would certainly have no particular basis in fact if that trend continues.

You obviously talk about the growth rate, but you've been wrong so many times—the administration has been wrong so many times I'm wondering when will you stop being so optimistic and have a more realistic figure, perhaps make the mistake on the lower side rather than on the high side.

What I am asking I guess is, are you forecasting the future in terms of guessing what the future is going to be, or have you set any specific goals for the future and then fashion policies and programs to reach some achievable goals? It seems to me that we are still talking about high unemployment; we are still talking about what may happen 5 or 6 years down the road, and we are ignoring the fact that we are dragging, as it were, in the economy. We are not achieving the economic growth rate that will pull us ahead. Productivity has been decreasing and yet we have no program or policy from the administration to address these problems and it would seem to me that if you're talking about forecasts rather than goals that you're making a drastic mistake.

Are the assumptions that you're building into the future based on forecasts or are they specific goals as the act itself—the Full Employment and Balanced Growth Act requires you to have those specific goals so that at some particular time some year in the future we can say that we're going to achieve these particular goals? If you're only forecasting them or guessing at them, Jimmy the Greek could do just as good a job I suppose as some of the economists in the administration.

Secretary **Baker**. Well, Congressman Hawkins, you don't have to convince me that in predicting the economy sometimes we can be less accurate than predicting the weather. I agree with that.

Let me get a plug in here for tax reform if I might. You say your constituents are not really worried about the W-4 because not enough of them are making enough money. This new tax reform bill would take 6.5 million working poor off the tax rolls. I think that's a goal that is——

Representative **Hawkins**. May I interrupt if I may at that point? They would rather have jobs and pay taxes. I think it's good that they have been exempted and we should not I think gloat over the fact that we have exempted them. We have exempted them because we have denied them jobs. They would be better off if they were productive workers in the economy and not——

Secretary **Baker**. I said 6.5 million working poor is what I'm talking about, but let me see if I can answer the other question which you posed which basically is that we have another rosy scenario forecast here.

I couldn't disagree more with that. We dropped our forecast of growth down from 4 percent, which is what it was for last year, for 1987 to 3.2 percent. It's only three-tenths of a percentage point, if I'm not mistaken, higher than the average of the blue chip forecasters.

You say we've always been too rosy. Let me correct that: four-tenths of a percent in 1987; the average of the blue chip forecasters is 2.8 percent——

Senator **Sarbanes**. 2.4, I think, Mr. Secretary.

Secretary **Baker**. I'm sorry.

Senator **Sarbanes**. The blue chip forecasters' average was 2.4, compared to 3.1 or 3.2 by the administration.

Secretary **Baker**. Ours is 3.2 percent, measured fourth quarter to fourth quarter. In relation to CBO, we are two-tenths of a point higher than CBO measured fourth quarter to fourth quarter. This year, of all years, I don't think we're coming in here with a rosy scenario forecast. We reduced it. It was a subject of considerable debate within the administration and we dropped it down so that we wouldn't be subject to that criticism.

You say that we've been wrong more than we've been right. So has CBO. The fact of the matter is, we've been wrong on the low side 2 years out of the 6 years that we've been here and we've been wrong on the high side 4 out of the 6 years—60-40. So I just can't accept that we have a rosy scenario forecast here.

We've added 11.5 million new jobs, as I indicated in my statement. I think that's pretty good performance on employment. We have 60.9 percent of the civilian population of this country working today, a record. So it seems to me that while there are some problems with the economy, which my statement addressed—namely, the fiscal deficit, the trade deficit—clearly, we're not happy with unemployment at 6.7 It's a lot better than the 7.2 or whatever it was when we first came into office and it's considerably better than the 10¾ that we saw at the height of the 1982 recession. I think we're making progress.

Representative **Hawkins**. Thank you.

Senator **Sarbanes**. Congressman McMillan.

Representative **McMillan**. Mr. Secretary, can I return a minute to some of the trade figures. Congressman Wylie pointed out the favorable December figures which were a reduction to $10 billion from the $19 billion in November. There was also a reduction from $15 billion in 1985, which would also appear to be encouraging. However, looking at them more carefully, I noted that the 1986 trade deficit in November was $19 billion against $13 billion the prior year. So the aggregate for 2 months is almost a standoff, which I would rather it be otherwise, but there is an economic theory—I suppose it's a theory—that when the value of the dollar is dropping there is a lagtime of that being reflected in trade figures, known as the *J* curve, and since we've been through a rather prolonged period of decline of the dollar, is there any way of predicting when that lagtime may end?

Secretary BAKER. Before I answer that, Congressman, may I just say, Mr. Chairman, that the difference of opinion a minute ago on the average for blue chip relates to whether it is measured fourth quarter to fourth quarter or year average to year average. Based on fourth quarter to fourth quarter blue chip is 2.8 and that is what I was talking about. Year to year it is 2.4, and that is what you were talking about.

Senator SARBANES. Are you talking about the blue chip forecast or CBO?

Secretary BAKER. CBO is 3.0, the average of the blue chip forecasters is at 2.8 percent fourth quarter over fourth quarter.

Senator SARBANES. What is your fourth quarter to fourth quarter figure?

Secretary BAKER. 3.2

Senator SARBANES. What is your yearly figure for 1987?

Secretary BAKER. 3.1.

Senator SARBANES. What is the blue chip forecasters yearly figure for 1987?

Secretary BAKER. Year to year is 2.4 and fourth quarter to fourth quarter is 2.8.

Senator SARBANES. Your yearly figure for 1987 is 3.1?

Secretary BAKER. Yes, sir.

Senator SARBANES. What is the blue chip forecasters yearly figure?

Secretary BAKER. 2.4, but fourth quarter over fourth quarter our figure is 3.2 and and blue chip is 2.8. That's what I was talking about in my answer to Congressman Hawkins.

Senator SARBANES. Well, I intend to pursue that when I come back.

Secretary BAKER. Congressman McMillan, economists tell us that it takes 12 to 18 months to see exchange rate changes reflected in the trade figures. We are 16 months away from the Plaza Hotel meeting and agreement as we sit here this morning. I can't predict for you when the exchange rate changes will in fact be reflected in the trade figures with any more specificity than that. The fact that it would appear that the trade deficit may be leveling off and not continuing to increase might indicate that those exchange rates changes are beginning to be reflected in the trade figures—might.

Representative MCMILLAN. Following on that for a minute, what steps can be taken with respect to those nations, particularly I think the Pacific Basin nations whose currencies are pegged to the value of the dollar in terms of addressing those problems in the same fashion?

Secretary BAKER. We can talk to them about the importance in terms of our trade relations that they let their currencies appreciate against the dollar and don't tie their currencies to the dollar and we are in fact doing that. And there has been some appreciation in those currencies since we started doing that.

Representative MCMILLAN. One other question on the trade and related international debt situation. I just recently returned from a visit to Central America and was able to talk to the Foreign Ministers of El Salvador and Nicaragua, believe it or not, and Honduras and Costa Rica, and I'm sure you're well aware of the tremendous problems they face. Three of those countries are trying conscientiously to deal with their problems. I'm not sure Nicaragua is. In fact, I think it's the only nation in default on its international obligations.

But would you comment for a minute or so about the success to date of the so-called Baker plan in addressing that problem. Perhaps in the process, address whether or not something that they suggest as an alternative, which is a conversion of debt to equity, is a realistic prospect in dealing with some of their problems?

Secretary BAKER. Well, let me take those in the reverse order in which you asked them, if I might, Congressman.

First of all, the conversion of debt to equity is a realistic possibility up to a point, depending upon the investment regulations and laws of the debtor nation involved. Clearly, that is the best way to go and we have indicated from the beginning that debt-equity swaps would be looked on with great favor. We are encouraging debt-equity swaps, we would like to see more of them and there is a growing market for them.

In terms of the progress that has been made on the debt problem, let me just say that in our view the debt problem, while it is still a serious problem for the world, is nowhere near as serious as it was in 1982 when it first broke upon the world scene.

In the first place, many banking systems of the industrialized countries are in better shape to handle whatever shocks might come their way as a consequence of problems in repayment.

Second, and more importantly I think, there's a general change in attitude on the part of most of the 15 major debtor countries, with Peru maybe being a singular or notable exception. Most of these countries are in fact adopting growth-oriented, free market type reforms of their economies. That's been taking place in many, many countries, including Mexico, the Philippines, Ecuador, Colombia, Uruguay, and Argentina. There's been substantial progress toward reform of these economies so that they can grow their way back and earn their way out of debt.

The multilateral institutions, and particularly the World Bank, are participating to a much greater degree than they were and this is very high on their agenda. The World Bank is providing, in addition to the traditional project and developmental lending, structural adjustment lending to these countries. And the bank lending portion of our proposal is finally beginning to take place. We have seen new lending packages recently for Mexico, Nigeria, Uruguay, and Ecuador. So I think our debt proposal is making good progress.

Representative MCMILLAN. I'd like to pursue that further but my time is up. Maybe we can come back.

Senator SARBANES. Certainly.

Senator Bingaman.

Senator BINGAMAN. Thank you very much, Mr. Chairman.

Mr. Secretary, let me just ask on your competitiveness initiative, which I commend you for—I think it's an excellent sign that the President is concerned about this issue and I know you've been concerned and have spoken on it for some time. Several of us here in the Senate put out a report on this issue in September and one of the leading journalists characterized our response to this serious problem as somewhat puny. I think the criticism was well taken because we did have a series of measures which were very modest.

I wonder if that same criticism can't validly be made of the initiative that you have put together or the administration has put together on this competitiveness issue. Specifically, I have problems reconciling your concern about the human capital development—I think that's the phrase that's used in your statement—your concern that we give more attention to human capital development with the proposals of the administration in the budget to eliminate Federal funding for vocational education and to substantially cut funding for math and science education. How do you reconcile those?

Secretary **Baker**. Well, first of all, let me say I would hope it wouldn't be characterized as puny, Senator Bingaman, because there are an awful lot of elements in it that don't involve just human capital and, of course, making America more competitive is going to involve continuing doing some of the things we are doing and some of the things we have been talking about here today, as well as some of the new things that are in the President's initiative, but let me answer your question if I might on education.

First of all, one of the best things we can do to make America competitive is to reduce this deficit of ours, and in reducing the deficit it's important to do it to the extent that we can, do at least some substantial part of it on the spending side.

We have to continue the discipline afforded to us by the Gramm-Rudman-Hollings targets and we ought not to abandon those targets.

Education funding in this country is largely furnished by State and local authorities. Traditionally it has been and I think that the Department of Education share of total funding or expenditures for education is less than 7 percent of the total, and the proposed budget request of $14 billion represents, as you point out, a decrease of about $5 billion from the 1987 appropriation but that proposed reduction will be more than offset by a $14 billion increase in spending for education from State and local and private sources.

That's the only way I know to answer your question, other than to add that in the human capital area we are calling for an $800 million program of job training for youth and a $980 million program of dislocated worker adjustment assistance. Those are significant expenditures in the area of human capital development.

Senator **Bingaman**. Well, would you agree with me that as a matter of priorities it does not make a lot of sense to put more money into dealing with unemployment and take money out of the basic education of people who are going into the work force at a later time?

Secretary **Baker**. I think it's a question primarily, Senator, of where the money comes from. You know that our view is that this has historically been a State and local government responsibility for the most part. The Federal Government's share is very small and while we recognize the importance of education, we cannot take on some of the measures that frankly require the expenditure of large amounts of money. There are new disciplines in what we might require in our high schools and that sort of thing.

Senator **Bingaman**. Let me ask on another issue, Secretary Schlesinger spoke to the Energy Committee or testified to the Energy Committee last week that in his view we had an energy policy which was a de facto policy of increasing energy dependence.

I notice in your statement and in your response to one of the questions that we were fortunate the decline in the dollar happened at a time when oil prices have been going down and that allowed us to avoid inflationary pressures.

Would you agree with the basic premise that we are getting ourselves into a situation where increased dependence on foreign oil is going to increase the vulnerability of our economy to serious economic difficulties down the road?

Secretary **Baker**. I don't know whether we could say serious economic difficulties, but I would certainly agree with you that to the extent that we increase the percentage of our total oil consumption by way of imports we are putting ourselves more and more at the mercy of those people who produce that foreign oil and we're making it much more likely, of course, that we could see the kinds of shocks that we saw in 1973 during the Arab oil embargo.

Senator **Bingaman**. Do you think as a part of the long-term economic policy of this country we ought to be trying to take some steps to avoid greater and greater dependence which seems to be the trend?

The evidence we've had is that by 1990 over 50 percent of our oil will come from overseas and certainly that's a problem.

Secretary **Baker**. I think that we need to be very conscious that it's important to this country as a national security matter that we have a viable domestic oil industry. I'll give you three steps that I think we ought to take that the administration supports and that we can't get enacted up here. We ought to repeal the windfall profits tax. We ought to deregulate natural gas and we ought to repeal the Fuel Use Act.

Senator **Bingaman**. Do you think any of those would impact on the extent of our foreign dependence significantly?

Secretary **Baker**. Sure. It would mean you would have more exploration and production in this country.

Senator **Bingaman**. My time is up. Thank you, Mr. Chairman.

Senator **Sarbanes**. Senator Melcher.

Senator **Melcher**. Well, Mr. Secretary, I agree with you on those three points. There's a lot of other things I don't agree on.

I want to ask you three questions and they are very short questions and I think yes or no will suffice for each of them.

First of all, perhaps the majority of the people who are recognized as good analysts of the tax bill we just passed say that GNP for the next three years is likely to be weakened. I don't know whether they're right or wrong.

One of the reasons they cite is the repeal of capital gains. What is your own personal view? Would you like to see capital gains reinstated?

Secretary **Baker**. Well, let me answer it this way by saying that was the biggest disappointment that we had frankly in tax reform was the differential for capital gains was repealed. We didn't like that aspect of the bill, but as you know there's not a line item veto so we got to take the bad with the good and we took that bad with the good.

Senator **Sarbanes**. You want a line item veto on the tax bill as well, then?

Secretary **Baker**. I think it ought to extend to all bills, Senator. [Laughter.]

At the same time, let me say that I don't think we ought to fiddle with the tax bill, so I would hope that my answer doesn't mean that we're going to go back in and reopen in a substantive way tax reform which we just concluded. I think we ought to cool it for a while and let the American people know what the ground rules are under which they have to operate.

Senator **Melcher**. Well, that answer is no now, yes later?

Secretary **Baker**. The answer is no now. I don't know what you mean by later.

Senator **Melcher**. Well, maybe reinstating the capital gains tax later. All right.

The dollar has depreciated, as you say, 40 to 50 percent against the yen and deutsche mark and perhaps close to that against the French franc. On agricultural exports, West Germany, France, and the European Community all have great barriers against importing agricultural commodities from the United States, as does Japan except for whatever they agree to take in.

So what effect will the falling dollar have on the exchange rate coming closer to the makes of Canada, Australia, Brazil, Argentina, and the other agricultural exporting countries?

Secretary **Baker**. Well, I think you have seen here recently some strengthening of the Canadian dollar. I cannot tell you how much effect that will have on agricultural exports in this country.

Senator **Melcher**. What is that? I live right next to Canada. I thought it was still 32 or 33 cents difference on the dollar.

Secretary **Baker**. It's gone from a little over 70 cents to about 75 cents here in the last 2 or 3 weeks.

Senator **Melcher**. So in other words, you think it's close to 25 cents difference?

Secretary **Baker**. Yes, sir. Well, I know it is today.

Senator **Melcher**. Today?

Secretary **Baker**. That's what it is, 74.7.

Senator **Melcher**. That isn't much, though, is it?

Secretary **Baker**. Well——

Senator **Melcher**. Is there anything to be done with Canada on an agreement with correcting the exchange rate?

Secretary **Baker**. Well, Senator Melcher, we have seen Canada over the last several years having to defend their dollar. Their economy has been considerably weaker than ours. The Canada dollar has tended to weaken and up until very recently, the recent stages of the decline of the U.S. dollar, the Canadians have had to defend their dollar.

So we have not taken the view that they are fiddling around with their exchange rate, tying it to the dollar for reasons of competitive advantage. And as we have seen here over the past 2 or 3 weeks, the Canadian dollar is beginning to rise.

Senator **Melcher**. So you're predicting that's going to continue?

Secretary **Baker**. Well, it depends on what happens I think to the U.S. dollar.

Senator **Melcher**. That doesn't help us much with all the surplus sitting around here in the United States and not being able to move it.

Now the last question is this. You mentioned lower interest rates. Agricultural interest rates are roughly 11 or 12 percent, both from commercial banks and from the Farm Credit System.

Do you have any proposals to help the Farm Credit System?

Secretary **Baker**. Well, we helped the Farm Credit System last year with the help of the Congress by restructuring the System, as you know, and it was given at that time a call on the Treasury which we hope very much it won't have to use. We are in contact with the Farm Credit System now to a much greater extent than we have been before and we hope that they are going to be able to work their problems and so do they.

Senator **Melcher**. The call on the Treasury would make it possible for the Farm Credit System to reduce the rates of interest to their borrowers?

Secretary **Baker**. No, it would not come into play until they were faced with the possibility that they couldn't continue to operate, Senator Melcher, at which time they have some call—and I don't remember the exact amount of it—on the Treasury.

Senator **Melcher**. But my question is, when they do have a call on the Treasury, will it help them to loan money to their borrowers?

Secretary **Baker**. Well, yes, it will help them to the extent that it will mean that they will be able to continue in business, the PCA's and Farm Credit banks will continue to operate.

Senator **Melcher**. But not necessarily——

Secretary **Baker**. It is not an interest buydown call, no, sir.

Senator **Melcher**. And you have no plans which you care to share with us?

Secretary **Baker**. Well, that was debated, as you know, last year and it ended up being rejected I think by the Congress as well as by the administration as the route to go.

Senator Melcher, may I just say we were very pleased to see yesterday a resolution of this dispute we have with the European Community on the access of Spain and Portugal and what that would have meant by way of penalties to our agricultural products moving into the EEC. We worked very hard to resolve that. It was resolved.

The biggest problem I see out here on the trade front, generally speaking, has to do with agricultural trade and we really need to work to solve that problem jointly with the European Community because the United States and the European Community have bigger subsidies for farm production of commodities which are in oversupply than any country in the world. And we've said in our multilateral discussions with the European Community that we can't work toward getting the American agricultural economy back to a market oriented basis, back to a free market type economy, unless they are willing to work with us. But if they were willing to work with us it's very important that we try and move in that direction in this country because it's the only real solution to these extensive surpluses that are building up worldwide.

Senator **Melcher**. My time is up, Mr. Secretary, but I will return to that point in the second round.

Senator **Sarbanes**. Thank you, Senator Melcher.

Senator Proxmire.

Senator **Proxmire**. Thank you, Mr. Chairman.

Secretary Baker, we all take great pride in you. You're a rose sitting up there in the administration in a garden of cactuses. I mean it. You're a cooperative, friendly, helpful, constructive, nonconfrontational witness from the administration and I hate to differ with you but I'm going to have to differ with you in what I think are some important respects.

The old truism, you view the glass as half full and I view the glass as half empty, and I view what's in it as loaded with arsenic and I want to tell you why.

First, all we really have on the deficit that we know about is what has happened. The first of Gramm-Rudman-Hollings ended September 30, 1986. What was the deficit? $221 billion, the biggest ever. And Gramm-Rudman-Hollings was in full effect. We had the biggest deficit ever, as I say, with it in effect.

Now we've had one more quarter just ended December 31 and the deficit was $63 billion. Now you give us a table here that represents realities and a dream. The reality ends, of course, in 1986 and we have this deficit that is breaking all records and we also have, as you point out, a series of reasonably favorable developments in the economy. The recovery continues, one of the longest recoveries. We have other very substantially favorable elements.

However, the reason we have that, if we've learned anything—and you learned this I'm sure in your economics courses in Princeton—is in very large part because we've had a series of record-breaking deficits. That stimulates the economy. That puts people to work.

Furthermore, the icing on the cake, of course, is what has happened with the Federal Reserve Board—an explosion of money, of credit. Erich Heinneman and others have called this a sea of money that we're operating in, an increase in M-1 of 17 percent, M-2, M-3 at very high levels relative to the nominal GNP. You put this together and they cause you to have an absolute record stimulus to the economy and we still are really kind of limping along. We're running enormous deficits and all we have on the basis of the record, not the hope and the dream but the record, is that we are bogged in a continuing deficit without any real economic progress.

What's your response to that?

Secretary **Baker**. Well, my response to that, Senator Proxmire, is that we've put in place some measures that are going to come to fruition without any further action on our part—when I say ours, I mean the Congress and the administration.

The fact of the matter is, Gramm-Rudman-Hollings has resulted in the exercise of a great deal of restraint on additional spending. Nondefense spending rose only by 1 percent in real terms last year. I think it was the lowest that it has been in many, many years. We have put in place, baked into the cake if you will, some deficit reduction measures that you enacted that we weren't entirely in agreement with because a lot of it comes out of our defense budget. It's going to mean that this $221 billion deficit is going to go down even under the worst economic assumptions you might want to make just to the range of $175 or $180 billion.

Senator PROXMIRE. I beg your pardon. Let me just point out that the administration itself estimates $173 billion deficit for next year. You're going to miss by another $30 billion your goal even if the administration is correct and that, as has been pointed out several times this morning, is based on a very optimistic estimate with respect to the economy compared to the consensus estimate.

Secretary BAKER. But, Senator Proxmire, I would submit to you that deficit reduction from $220 billion to $173 billion is one big step in the right direction.

Senator PROXMIRE. We haven't obtained it, though. That's the dream. That's what's going to happen. The first quarter which we have so far is a $63 billion deficit in 3 months. That's what we know about. Are you saying, yes, but what we have is we're going to get down to $173 billion? Well, that's what you hope for.

Secretary BAKER. Well, I think that's the general direction—I might say that the Federal Reserve Board agrees with that. Their figure is $180. Ours is $173. CBO agrees with that. Their figure is $169. So all we can do is go on the best estimates we have and these are the best estimates.

There were substantial reductions in defense budget authority enacted last year and the year before and they're going to start coming onstream by way of outlays this year and I think we're going to see a substantial deficit reduction in 1987.

Senator PROXMIRE. So far what we've talked about is the Federal debt. A much bigger debt, of course, is the personal debt. The personal debt in this country is now at $2.6 trillion. Corporate debt is over $3 trillion. It's rising very rapidly. Savings are the lowest in relationship to income that it's been ever, far lower than in other countries, and I think it's tragically low. Now we have a monetary policy that's encouraging that by holding interest rates down. Senator Melcher doesn't like it. Nobody likes it. People up here on the Hill are always calling for even lower interest rates and ever lower interest rates, but the fact is, when you have this artificial kind of stimulus of the money supply by the Federal Reserve you have an interest level that encourages debt and discourages savings.

And when you have this combined policy of tremendous deficit spending and monetary stimulus, you can go along for a while, but I think any notion that we've repealed the business cycle and there won't be another recession is really wishful thinking and if, as you say, we're in the 5th year, one of the longest recoveries ever—if we have a recession, then the deficit is very likely to go to $300 or $400 billion.

Secretary BAKER. Well, Senator Proxmire, we've differed on this over the past—I say we—the administration and you—over the past 4 years. There were some in our administration even back in 1983 who were predicting that we were going to hell in a handbasket, we're going to have this great——

Senator PROXMIRE. Exactly where we have gone as far as the debt is concerned.

Secretary **Baker**. Well, I don't think it's where we've gone as far as the economy is concerned. You look at the factors that I cited in my remarks, this is a very good economic performance and I just don't agree that we're set to fall off the edge of a cliff here and that all is doom and gloom.

Senator **Proxmire**. Well, my time is up, but it's like the fellow who's just had his third martini and is feeling great and says, "This is wonderful. We'll have a few more, we'll feel greater," and on and on. And, of course, the next morning there's a hangover. And the next morning always comes and the next morning comes in our economy.

We have a free enterprise system. We have recessions and recoveries. You just pointed out to this committee we've had one of the longest recoveries ever. We're going to get a recession, maybe not on your watch—probably on your watch, but not certainly. When we get it, it's going to be a real lulu in view of the tremendous debt people have—the bankruptcies we'll have in corporations, the bankruptcies we'll have in personal bankruptcies, and an administration unable to help because we've used up our fiscal stimulus, we've used up our monetary stimulus.

I think it's time to get off that happy, rosy cloud that you and the President ride so beautifully and get a little gloom and doom. [Laughter.]

Senator **Sarbanes**. Otherwise known as realism.

Mr. Secretary, I have one rather tangential question before I return to some of the economic ones.

Philosophers write a lot about intentions often meaning what people intend when they use certain language. When you say you have no present plans in the morning of a day, does that mean you could have different plans in the afternoon of the same day?

Secretary **Baker**. What it really means is that no decision has been made, as I sit here this morning, to have a G-5 meeting.

Senator **Sarbanes**. Does that mean it's being considered, that a decision may be made?

Secretary **Baker**. I think it's clear that there is some consideration being given to the possibility, yes, sir.

Senator **Sarbanes**. Thank you.

I want to come back to Congressman Hawkins' point and to some extent the one that Senator Proxmire followed up on—these rosy predictions and the rosy forecast.

For 1986, the year we're in, am I correct that the administration's predictions for real GNP growth was 3.4 percent?

Secretary **Baker**. For 1986?

Senator **Sarbanes**. Yes.

Senator **Proxmire**. 1987.

Senator **Sarbanes**. No, 1986.

Secretary **Baker**. No, sir, that's the blue chip.

Senator **Sarbanes**. No, for 1986.

Secretary **Baker**. For 1986, fourth quarter to fourth quarter, the blue chip consensus was 3.4 and the administration was 4.0.

Senator **Sarbanes**. And what was your prediction for the year? I don't want fourth quarter to fourth quarter. I want it for the year.

Secretary **Baker**. I don't have that right here in front of me.

Senator **Sarbanes**. 3.4 but it would have been about 4.

Secretary **Baker**. Oh, you mean revised in August? Do you want the original or the revised?

Senator **Sarbanes**. I want the original. I'm going to come to the revised in a minute.

Secretary **Baker**. My recollection is the original was 4, but I'll have to ask—roughly 4.

Senator **Sarbanes**. Well, 4 is going to show you worse off. I want to be fair to you here. As I understand it, your prediction for the year for 1986 was 3.4 percent and the actual for 1986 was 2.5 percent.

Secretary **Baker**. That's right.

Senator **Sarbanes**. Now in August 1986, in predicting the second half of 1986, as I understand it, your prediction was 4 percent. Is that correct?

Secretary **Baker**. That's correct.

Senator **Sarbanes**. And the figure for the second half was 2.3 percent actual. Is that correct?

Secretary **Baker**. I assume that is correct, yes. It sounds right.

Senator **Sarbanes**. Okay. So in 1986 for the year the administration's prediction of real GNP growth for the entire year was 3.4 percent. In actuality, it turned out that the growth was 2.5 percent. In August 1986, just predicting the last half of the year we were then in, the administration predicted 4 percent. The actual was 2.3 percent.

Now for the year 1987, the administration's prediction is 3.1 percent and the prediction of the blue chip forecasters is 2.4 percent.

Secretary **Baker**. That's right.

Senator **Sarbanes**. In fact I'll read from their statement. This is from the blue chip economic indicators: "On real GNP, the consensus forecast for 1987 economic growth by our panel of more than 50 top economists was shaded downward again to a sluggish year-over-year advance of just 2.4 percent, with this quarter's growth down to 1.8 percent." That was the last quarter of 1986. This is in contrast to the assumption of 3.1 percent gain in real GNP during 1987 that was projected by the Office of Management and Budget in support of the new 1988 $1 trillion budget.

In view of all this, the 1986 year forecast of 3.4 and actual 2.5, the forecast in August 1986 for the last half of that year of 4 percent, an actual of 2.3 percent, a prediction for 1987 of 3.1 percent contrasted with the blue chip consensus forecast of 2.4 percent, what is your response to the contention that you're offering consistently an over favorable forecast on economic performance?

Secretary **Baker**. My response to that, Mr. Chairman, is that we don't consistently place an overly favorable estimate. In 1983, our estimate of real growth for the year was 3.1 percent and we grew at 6.1 percent. In 1984, our estimate of growth was 4.5 percent and we grew at 5.6 percent. In 1987, as you have pointed out, our year-over-year estimate is 3.1, but your own Congressional Budget Office's estimate is 2.8.

I don't think that three-tenths of 1 percentage point difference means that we are out here consciously smoking up the figures.

Senator **Sarbanes**. I'm using the blue chip because that's what you used earlier in making your reply, and, of course, that's at 2.4.

Secretary **Baker**. If you use the blue chip fourth quarter over fourth quarter, then ours is 3.2 and their's is 2.8.

Senator **Sarbanes**. I'm quite prepared to concede the point that the economy performed more strongly in 1983 and 1984 than anyone expected and I think that's a useful reminder of the hazards of economic forecasting.

On the other hand, it seems to me that obviously we have to deal with the period which we are in now. With respect to this period it seems to me that the administration is being overly optimistic. I have great difficulty in understanding how you could make a short-term prediction of 4 percent in August for the last 6 months of 1986, the period we were then in, and come up against an actual figure of 2.3 percent.

Secretary **Baker**. Mr. Chairman, if we're being overly optimistic, so is your Congressional Budget Office. I mean, we're at 3.2 fourth over fourth; they're at 3.0. That's practically no difference. We're at 3.1 year over year; they're at 2.8, three-tenths of 1 percentage point.

Senator **Sarbanes**. Well, what's your answer on the August prediction?

Secretary **Baker**. We missed. We missed in 1981 too on the low side.

Senator **Sarbanes**. You missed very substantially in August, didn't you? The 4 percent as opposed to 2.3. That's a pretty substantial miss.

Secretary **Baker**. And we missed on the low side, if I may say so, substantially in 1983 and 1984. We were way low and so were you way low up here.

Senator **Sarbanes**. Let me ask you this final question.

The administration projects that the budget will be in balance by 1992 on the basis of its long-range economic forecast. That economic forecast includes the following assumptions: (1) No recession before the end of 1992, which would give you the longest period of growth in the history without any downturn whatever; (2) growth averaging 3.5 percent over the period; (3) a steady decline in the unemployment rate to 5.5 percent; (4) a steady decline in interest rates. For example, the interest rate on 10-year Treasury notes would come down from 7.7 percent in 1986 to 4.5 percent. And inflation, which after rising in 1987 from the very low level of 1986, would then decrease steadily to 2 percent.

Those were the assumptions behind the administration's forecasts.

At a hearing last week we asked two prominent economic forecasters about the probability of all of these developments occurring simultaneously over the next 6 years, which is, of course, the assumption of that prediction. They both said that the chances were infinitesimal.

Do you realistically believe that all of those assumptions could be met over the next 5 years?

Secretary **Baker**. Mr. Chairman, I would say that when they say that the chances are infinitesimal, I would say that they are being too generous. I don't think there's any chance at all that all of those will occur simultaneously over the next 5 years because I don't think anybody can predict with that kind of degree of specificity or certainty what's going to happen in all these economic indicators 5 years down the road. We simply can't do it.

Senator **Sarbanes**. Well, then, why do you make these projections?

Secretary **Baker**. Because you require us to.

Senator **Sarbanes**. And you think these are the most realistic ones to make in that circumstance?

Secretary **Baker**. We think they are realistic. Clearly, they won't all simultaneously occur. We know that. We're required to make the projection.

Senator **Sarbanes**. All right.

Congressman **Wylie**.

Representative **Wylie**. Than you, Mr. Chairman. I think you've made the point that there are some hazards in economic predictions.

The other day I made the point to Walter Heller and Richard Rahn of the U.S. Chamber of Commerce, both predicted that year to year the gross national product would be about 3 percent for 1987, which is within the range that Secretary Baker is talking about.

Now just briefly to recoup on a fourth quarter to fourth quarter basis OMB and CBO basically agree on the gross national product real growth. That's the point you really wanted to make, wasn't it?

Secretary **Baker**. Yes, sir.

Representative **Wylie**. Okay. But may I say that I'm a little bit upset, maybe disappointed, that a distinguished gentleman like the Senator from Wisconsin would make such a prediction about bad times. I remember another fellow talked about a malaise in the country and there was a malaise in the country and I think I like the optimistic approach a little better. I think there's something psychological about having an optimistic feeling about the way the country is moving.

And I say that because on this blue chip report which you have in front of you and to which you have alluded to several times about on the 1987 year to year, they predict a GNP of 2.4 percent, but the next paragraph says, "The good news is that there is expected to be a 3.3 percent for 1988." I don't know if you saw that paragraph or not.

Secretary **Baker**. Yes.

Representative **Wylie**. You haven't referred to it, but it seems to me as if that's something that we can be optimistic about and I would like to get that in the record.

A little earlier we were talking about the decline of the dollar and what significance that has as far as the trade balance is concerned and I wanted to get back to that. You alluded to that a little earlier.

For some time the administration has been saying that the dollar is too high and now that it's fallen significantly there are reports that the administration is trying to stop the drop, if you please, and I heard your answer to a question about that yesterday and I thought it deserved repetition for the record here.

You're not attempting, as I understand it, to stop the drop at this point in time and you are, rather, letting the market determine what the value of the dollar should be. Isn't that correct?

Secretary **Baker**. Well, that's correct, Congressman Wylie, although I would not want my acknowledgment of that to be interpreted to mean that we are somehow talking down the dollar because quite often the foreign exchange markets will put unwarranted inferences on something we might say.

The fact of the matter is, we do not talk about what we might or might not believe the appropriate level of the dollar is and we should not talk about it.

Representative **Wylie**. I guess the point I wanted to make in my observation earlier is that I think there are enough positive signs about the state of the economy that we do need to brag a little and I think it's appropriate for you to do a little bragging on behalf of the administration.

Just recently, the Speaker of the House suggested freezing the 1987 transitional tax rates as an effort to bring down the budget deficit. Much has been made of the budget deficit and it is a very serious problem and I think most people across the country still feel it's the most serious problem facing the Nation and I agree with you that we need to try to meet the Gramm-Rudman targets.

What would be your comment to that? I think you have commented on it publicly before but I'd like to get it on this record.

Secretary **Baker**. Well, Congressman Wylie, I think that would be an extremely unfortunate position for us to take. In my view, that would mean we would be breaking a compact with the American people and it is my further view, as I've testified before, politically it just isn't going to happen on this President's watch because I don't think you're going to see two-thirds in both Houses that would support it, and he would clearly not support any such effort.

Representative **Wylie**. We are attempting to come to some sort of consensus on a trade bill and I think the Speaker has announced that we are going to get to bring a trade bill to the House floor early on as one of his next priorities and I think it should be one of his next priorities.

What sort of trade bill would you like to see conceptually?

Secretary **Baker**. Well, the administration will be sending its legislative package forward within about another 2 to 3 weeks, Congressman Wylie, and it will contain specific provisions with respect to trade legislation, but it will also contain provisions that have to do with other elements and aspects of the President's competitiveness initiative.

Are you asking me generally what might be contained in the package or are you asking me about the trade portion?

Representative **Wylie**. I know that the administration generally is opposed to protectionism and yet there have been some examples recently of arrangements which would amount to protectionism, especially in the semiconductor industry field and in the grain market vis-a-vis the European Common Market.

Secretary **Baker**. Well, the omnibus legislation will, of course, contain all of the elements of the President's competitiveness package, including the resubmission of some things we've sent up before such as product liability or foreign antitrust reform. We'll have the job training and the dislocated worker adjustment assistance provisions. We will have intellectual property protection. We will ask for authority to negotiate a new Uruguay round of the GATT. We will suggest changes in section 201 and 301 of the Trade Act. We will suggest shortening the timeframes within which action must be taken. We will have suggestions for additional grounds for section 301 unfair trading cases.

These are some of the things that will be in the package. It's going to be a rather extensive package and I think you will see that some of the elements of the package represent a clear step forward from the administration's position with respect to some of these issues last year.

Representative WYLIE. I think it will be important for the administration to get that up early on so we can try to develop a bipartisan approach to this problem. Thank you, Mr. Secretary

Senator SARBANES. Congressman Hawkins.

Representative HAWKINS. Mr. Secretary, I don't want to return to the matter of economic growth rates. I think that has been clarified to some extent anyway.

My criticism was not that you were too optimistic, but that you were not achieving the optimistic goals that were currently implied by the assumptions being made. Even the 3.5 percent, if that would be achieved, would still leave us far short of the historical growth rate that is needed and I would hope that we don't settle for something like that which is itself inadequate.

But let me return to the question of education because I was somewhat amazed at the answer that you seem to have given to that question.

The reductions in Federal aid to education have been made under this administration since 1980 amounting to about 25 percent—some would say 22, but it certainly has been substantial. Again it is proposed that the reduction made in Federal aid will amount to about $5.5 million with the elimination of a number of programs.

You seem to have answered that question by saying that, sure, that is true—that was my understanding that you admit that these reductions are being made——

Secretary BAKER. Yes, sir.

Representative HAWKINS. But the slack would be assumed by State and local governments, which means to me that what you're saying in effect is that, sure, we are going to go on reducing the Federal aid to education, we are ignoring the problem of illiteracy in this nation, we are ignoring the fact that in terms of literacy this nation stands about 15th among the industrialized nations and that one-third of the adult population is functionally illiterate—that is, reading at less than the ninth grade—and then you suggest that we are going to have a huge Federal retraining program that's going to do something to reach the productive work force that's in competition with Japan, West Germany, and other countries, that outrank us in terms of literacy, and that we have a population of one-third reading at less than the ninth grade and that somehow we're going to retrain these individuals who really are functionally illiterate at this time.

It seems to me there's a conflict in what you're saying and that you're saying in effect that the problem is not national concern but that we're going to leave it to the States and the local governments, two-thirds of them being already in recession stage—that is, they've cut back on their State contribution to education. They're going into sales taxes and they are even turning to lotteries and other exotic ways of trying to keep their contribution to education up—there is no evidence whatsoever that this slack, as I understand it and as Chairman of the Education and Labor Committee we've had no documentation that the States are willing to assume this great load—as a matter of fact, it's just the opposite, and I don't see how the administration can possibly rely on the States and local governments to assume this great responsibility at the same time that we're talking about coming in with a package to make us more competitive, to take individuals who are functionally illiterate and somehow we're going to retrain them to meet the future.

It just seems to me there's a contradiction in the position that you have expressed in terms of the administration.

Secretary **Baker**. Well, Congressman, let me say that it is our view that the problem is a national concern and the President speaks to it in the message and he speaks to it as well in his competitiveness initiative.

At the same time, we think it's best handled at the local level. And my original answer simply pointed out that we have from 1980 to 1986 seen significant increases in spending on education, from $166 to $266 billion. This year alone, spending is expected to be up almost $16 billion to a total of over $282 billion.

Now our difference with you is simply that we think this is best done at the State and local level, not that we are ignoring these problems of illiteracy, but we do have to reduce this deficit and our view is that in the field of education the focus should be on the ever-increasing amounts that are being contributed by State and local governments.

I might say, too, with respect to your comments that the States are in such hard shape, the States overall are in surplus. The Federal Government is in deficit—significantly in deficit, as we all know. The States, many of them—not all—many States will benefit substantially in terms of enhanced revenues as a consequence of tax reform. The 34 States that tie their income taxes to the Federal system—that is, take a percentage of adjusted gross income—are going to have significantly increased receipts because as we broaden the base and increase the adjusted gross income of all taxpayers, the States' percentages will be far greater.

Representative **Hawkins**. You're talking about some States, Mr. Secretary. You're not talking about two-thirds of the States who are unable to do it now. Many of them—my own, California, has a tax limitation. It cannot spend any more on education because it's up to that limit. And you're defending a reduction in the Federal aid and using an amount which includes State and local governments but a reduced Federal aid.

The point that I am trying to clarify with you is that any concern at the Federal level in terms of funding which has increased from 11 percent in 1980 to currently a little over 6 percent, a declining contribution on the part of the Federal Government—if that is so, then it seems to me we should not be talking about the quest for excellence, we should not be making these great phrases about the value of education, and then cutting back on the effective federally supported educational programs. It just doesn't make sense that we are headed in the proper direction.

Secretary **Baker**. Well, Congressman, again, our differences are that it's best handled at the local level and the quest for excellence doesn't mean that we should necessarily increase the budget for the Education Department and try and handle it at the Federal level.

Representative **Hawkins**. Mr. Secretary, it's a quest for the States and local governments to do the job and for the Federal Government to get out of the business of dealing with education. That's the quest.

Secretary **Baker**. Well, that's where we have a fundamental disagreement between us.

Representative **Hawkins**. Well, it's a philosophical disagreement.

Secretary **Baker**. That's what I mean.

Representative **Hawkins**. But then we should stop talking about doing something for the functionally illiterate. We should stop talking about doing something for adult illiteracy if we're not going to do it ourselves and say, well, look, the elected officials at another level—we're going to leave the problem to them.

Secretary **Baker**. I don't think the mere fact that we're not going to spend Federal money means that the President of the United States should not highlight problems that can best be handled at the State and local levels, Congressman, and that's what the President is doing. He's pointing up the fact that we ought to focus on this problem and we ought to try and deal with it, but that it is best dealt with at the State and local levels.

Senator **Sarbanes**. Well, Mr. Secretary, I want to be sure I'm very clear on the point you're making when you say there's a basic philosophical difference.

Is it the administration's position that the Federal Government ought not to be contributing financially toward education?

Secretary **Baker**. I don't think it's that black and white, Mr. Chairman.

Senator **Sarbanes**. But that's the direction in which you would like to work?

Secretary **Baker**. In the light of the severe budget constraints that we are under today and given the size of our deficit and the fact that States for the most part are in surplus, of all the things that we have to deal with, this one is best handled at the State and local levels and, if we can generate additional support at the State and local levels, those dollars will be spent a lot better than the dollars we might throw at it from here. That's the difference.

Representative **Wylie**. Would the gentleman yield?

Secretary **Baker**. But let me say one other thing. I'm not the Secretary of Education, either, and you're talking about——

Senator **Sarbanes**. Well, some of us wish you were, but that's another point.

Secretary **Baker**. You're talking about some detail with respect to that budget that, quite frankly, I'm not the best witness on.

Representative **Wylie**. Some members of the National Association of School Boards were in my office and I looked at these figures and I thought there was an increase in the fiscal year 1988 budget for education.

Secretary **Baker**. No, sir.

Representative **Wylie**. Do you know what the budget figures are?

Secretary **Baker**. The budget request is $14 billion representing, Congressman Wylie, a decrease of $5.3 billion from the 1987 appropriation.

Senator **Sarbanes**. Congressman McMillan.

Representative **McMillan**. Mr. Secretary, could I return just briefly to the idea of debt conversion to equity in restructuring some of the international debt, particularly developing countries. Is there specific legislation that we should be looking at to address that question?

Secretary **Baker**. I don't think so, Congressman McMillan. I'm not quite aware of any. The fact of the matter is, you will get more debt-equity swap opportunities if these countries will continue to move toward free market economic policies and reform of their economies, if they will continue to reduce the restrictions on foreign investment that pertain, and if they will continue to so reform their economies so that capital flight begins to reverse and that sort of thing. Then you will get people interested in investing money there.

I am not aware of any legislation that's needed.

Representative **McMillan**. Well, there are some commercial banks in this country that are rather extended and they have problems I think in terms of taking the same action when it's in their loan portfolio and they could work out perhaps, if it were converted to equity, but our laws don't accommodate that very readily.

Could that be dealt with by a ruling by the Fed or the Comptroller?

Secretary **Baker**. Well, I suppose the regulators could deal with that if it were a serious restriction. My sense of it is that there are more opportunities—well, I'm sorry—there's more interest in debt-equity swaps on the part of the creditors than there are real opportunities for debt-equity swaps in the debtor countries.

Representative **McMillan**. One further point. We've been talking about the statistics—gross national product, which certainly is an important assumption in what we are about, but would you care to translate that into expectations in terms of new job creation? In other words, what does a projected 3.1 percent real growth rate mean in terms of new job creation for the 1987 economy even if some do believe it's a rosy forecast?

Secretary **Baker**. I'll get it for you, Congressman. I don't have the exact number of new jobs that we would expect to be created if we generated 3.1 percent growth. But as I indicated before, since the end of the recession we've created 11.5 million new jobs. Now we had—again as I pointed out—a good 1983 and a good 1984. Some would say we didn't have a good 1985 or 1986, but there were 11.5 million new jobs there. Overall, that growth rate, on average those last 4 years, was about 4 percent. So at 3.1 we could expect to generate quite a few new jobs. I just don't have the number.

Representative **McMillan**. I have no further questions.

Secretary **Baker**. I'll get it for you, Congressman.

Representative **McMillan**. Thank you.

Senator **Sarbanes**. Thank you very much, Congressman McMillan.

Senator Proxmire.

Senator Proxmire. Thank you, Mr. Chairman.

Mr. Secretary, I'd like to turn to the trade matter. You made the point that the decline in the value of the dollar has been helpful, and it certainly has been with respect to trade with relation to some areas. During the past 2 years, the dollar has declined about 45 percent I understand compared to the yen, the Swiss franc and the German mark; about 35 percent for other European currencies and about 30 percent with respect to the pound.

However, over the same period, there's been a reverse effect in some areas or no effect. Canadian dollar, Korean won, and the Hong Kong and Singapore dollars are about the same. The Australian dollar is weaker. In other words, we're at a greater disadvantage by 15 percent. The Venezuelan Bolivar, 100 percent. That affects, of course, our oil situation. The Brazilian cruzado, 300 percent; and Mexico——

Secretary Baker. You said the Brazilian affects our oil?

Senator Proxmire. No. I said against the Brazilian cruzado, the dollar has risen 100 percent or the cruzado has fallen.

Secretary Baker. Yes, but I thought you said and of course that affects our oil situation.

Senator Proxmire. No. That affects coffee, but we don't have that much consumption. I'm sure it affects some other products, but my point was that with respect to Venezuela it affects oil and with respect to Mexico, 370 percent.

Now when you put all these together, as the Dallas Federal Reserve Bank has done, as you undoubtedly know, they have developed a more representative index of the dollar which includes 131 countries with which the U.S. trades. On that basis, the dollar is only 5 percent weaker than it was at its peak in early 1985.

So far there's been, overall, with weights applied and so forth, there's been very little improvement.

Secretary Baker. Well, I'm not sure that the United States is in deficit to all those countries that the Dallas Federal Reserve used.

Senator Proxmire. Not necessarily, but——

Secretary Baker. I'm aware of that study, but I don't think that I have any difference of opinion with you on that. The study is factual.

Senator Proxmire. What the study shows, however, is that overall we have not really improved our status with respect to trade by the change in the value of the dollar against the German mark and yen and so forth and these other situations which have deteriorated.

Secretary Baker. I don't think it means that.

Senator Proxmire. Some, but not very much.

Secretary Baker. I do not think it means that, Senator Proxmire. What it means to me is that if you look at all the currencies, the decline of the dollar is significantly less than if you just look at the G-5 or G-7 currencies, and that is absolutely true and I agree with that.

But I do not believe that all of those—don't hold me to this—but I don't think all those countries on that list that were looked at in that study have trade surpluses with the United States. So I don't think it follows necessarily that we are not going to see any beneficial effect from what has happened with respect to the dollar.

But whether it does or does not mean that, we nevertheless should have done what we did because had we not done it, the trade numbers would be even worse.

Senator PROXMIRE. Well, whether we had trade surpluses or trade deficits—we'll always have trade surpluses with some and trade deficits with others and we can expect that.

Secretary BAKER. That is correct, but you should not expect the dollar to decline against all currencies, I wouldn't think, to the extent it's going to be affected by trade related flows——

Senator PROXMIRE. But you should expect it to decline overall. Here's my point. You take certain areas. Take manufactured goods. The dollar is worse off than it was 2 years ago with respect to manufactured goods overall—9.4 percent worse off. Chemicals and related products, 10.5 percent worse off. Inedible crude materials, 14.4 percent worse off. Food and live animals, 35 percent worse off; and minerals, fuels, and lubricants because we import so much from underdeveloped countries whose currencies have deteriorated even more, 60 percent worse off.

So you put all that together and I can't see that the change in the value of the dollar—it's not just a J curve problem, it's a problem in which we have not had that much improvement overall.

Secretary BAKER. Well, if you look at those on that basis, that's correct, Senator. But again, I would ask, where do you think we would be if we hadn't done what we've done.

Senator PROXMIRE. Well, I agree. I agree wholeheartedly. I think there's no question in my mind at all that what you've done is right and I support it enthusiastically. I'm just saying what we've done has not to date, on the basis of the developed record, given us a trade advantage which many people feel we have because we're all so conscious of Japan and Germany.

Secretary BAKER. Well, some of those countries I think are not in surplus to us. That's number one, so you wouldn't necessarily——

Senator PROXMIRE. What difference does that make?

Secretary BAKER. Well, you would not expect the dollar to decline against those countries that are in deficit to us and whose economies are going to pot. The fact of the matter is, their currencies are going to decline much faster than the dollar because——

Senator PROXMIRE. That may be the case, but when you look strictly at trade and if the whole situation has only improved 5 percent, not 30 or 40 percent as the general impression has been, obviously we are in considerable difficulty still and we're going to continue to be.

Secretary BAKER. I think what it means, Senator, is what we have been saying for some time, you should not look for exchange rate changes alone to solve the trade problem. We have said that from day one. We said it after the Plaza. Just that alone is not going to solve the problem. I quite agree with you.

And without having analyzed each and every one of the relationships and countries that are mentioned in that study, but I——

Senator PROXMIRE. My time is up. Thank you.

Senator SARBANES. Senator Melcher.

Senator **Melcher**. Mr. Secretary, in the previous round you made the comment that, in regard to agricultural trade, the settlement arrived at over the past 24 or 48 hours with the European Community was good news, for instance, for corn farmers.

The fact is that when Spain decided to join the Common Market, that meant that the trade barriers that the Community has applied to Spain and the 4 million—just one item—metric tons of corn that has been sold to Spain annually probably was in jeopardy. The result of that negotiation means that 2 million metric tons of corn from the United States will be allowed to be sold to Spain. So the corn farmers just weren't too well off the previous year, so that means this year they're going to get 50 percent of what they got in the previous year in sales.

The point I'm trying to make, Mr. Secretary, is: While the dollar has declined in some of the European countries and Japan, that isn't what controls our agricultural exports.

Secretary **Baker**. I'm not arguing with that all all, Senator.

Senator **Melcher**. I know you're not. I know you recognize that.

Secretary **Baker**. I do.

Senator **Melcher**. So I think it's a fiction for people to keep saying, well, as the dollar declines our agricultural trade ought to pick up.

Secretary **Baker**. Senator, may I just interject there? I didn't mean to leave the impression with you that I was blessing each and every element in that agreement between the United States and the EEC because, quite frankly, it was just concluded yesterday and I'm not familiar with each and every one. The point I was trying to make was, I think it's extremely fortunate that we didn't find ourselves in a big trade war as a consequence of this dispute because I'm not sure it's one we would have won. That was the only point I was trying to make. I wasn't trying to speak to the levels of corn exports that are permitted by the agreement.

Senator **Melcher**. Agricultural producers are hurting badly enough that they might like a trade war. As the corn growers' spokesman was quoted this morning in the news stories, "We would like a trade war. Maybe that's what we need. We only come out of this with half of the sales we used to have with Spain." Now that's just one very small item.

What needs to be done I suppose is a firmer, tougher stance by our negotiators with the Community and with Japan on not cutting back on agricultural products from the United States but maintaining at least the same level. That didn't happen with the corn in the question of Spain.

But let me turn to the area that I think we must be looking at on agricultural trade from the United States and must increase and do it promptly, and that's with the lesser developed countries because the increase we had in the real expansion of agricultural exports in the 1970's was with the lesser developed countries taken away. The only way we can do it now is with long-term credit or through Food for Peace. Now we seem to be reluctant to use all the authority that we have in our law to use the long-term credit or other means of a sale that can be made to a country such as the Philippines or Mexico. Their economy is so bad that it doesn't make any difference how cheap this American grain gets. What they have to have is credit and there's no reason in the world why we can't extend long-term credit to them and by that I mean 5, 10, 15 years, whatever they want.

Second, Food for Peace has been successful over the past 30 years in developing trade with developing countries. Yet, the budget has a cut in Food for Peace. It seems like we're not utilizing the weapons we have, the tools we have, to start moving ourselves out of our dilemma on declining agricultural trade.

Thank you, Mr. Secretary.

Senator **SARBANES**. Mr. Secretary, I have just a couple of concluding points.

We spoke at the outset about the necessity or the need for Japan and Germany, which are running the largest current account surpluses, not only to concern themselves with expanding their own economies as an engine of growth—although I've seen some figures that the impact of that on the U.S. trade deficit would be in the range of $10 billion, in other words, not overly significant—but also to concern themselves with moving some of that surplus capital into the developing world, to allow the developing world to move on to a growth pattern. You indicated agreement with that and I wondered what approaches are being considered in order to achieve it?

Secretary **BAKER**. Well, Mr. Chairman, before I answer that question may I give Congressman McMillan the answer to his question about how many new jobs? In 1987, the figure would be 2.2 million additional if the rate of real growth were 3.1 percent.

Mr. Chairman, the Japanese Government has indicated an interest in making additional funds available to lesser developed countries through the multilateral institutions. They have contributed I think an extra roughly $500 million—maybe it's $450 million—toward IDA-8. They are having discussions as far as I know with the International Monetary Fund and the World Bank with respect to making some additional capital available. I do not know all of the details.

It seems to me that the suggestion you made is a good one, that these countries that have these extraordinarily large surpluses have some obligation to see if there's some way that they can be recycled, if you will, toward assisting lesser developed countries so that we can have more generalized growth around the world and so that we can help some of these lesser developed countries that are seriously indebted find a way out of those debt burdens that they are now carrying.

I think there's an interest on the part of those surplus countries in doing that.

Senator **SARBANES**. I want to underscore the importance of doing it on a multilateral basis, to which you made reference, because I know there have been some proposals in Japan to try to do this on a bilateral basis. Invariably, when it's done on that basis, the trade is tied. The negative aspects of the situation are then only compounded, rather than a contribution made toward solving them.

Secretary **BAKER**. We have been encouraging them to the extent that we can in other multilateral fora to make those contributions on a multilateral basis for the reason you outlined. We have been very aggressive over the course of the last 2 years in trying to end the practice of tied aid credit, Mr. Chairman, and as you know, we have a request up here for—had a request last year for $300 million for that express purpose so that we could match, in order to bring some countries to the negotiating table—you gave us $100 million of it. We'd like to get the other $200 million this year so that we can fight that predatory practice of tying aid. We've made it clear to the Japanese Government that we don't think it's appropriate to try and do that on a bilateral basis; they ought to do it on a multilateral basis.

Senator **Sarbanes**. Finally, I think it was clear that the dollar was overappreciated and that we were suffering unfairly because of it in trade terms. Now what one's judgment is about the current level I think is a complicated question.

When did you become the Secretary of the Treasury?

Secretary **Baker**. On February 3, 1985.

Senator **Sarbanes**. And I note that it was in September 1985 that we had the Plaza meeting and began to address this currency overvaluation question. It was long overdue.

My concern is that what was achieved in that period of overvaluation entrenched market structure in such a way that currency changes now have difficulty in altering the trade terms. I think that's one of the reasons that the numbers have not shifted as anticipated and that our exporters lost their market position internationally. It's extraordinarily difficult for them to come back in again once they've been replaced.

Secretary **Baker**. I absolutely agree with that and that's why we've said from day one you cannot expect to correct the trade deficit solely on the exchange rate side alone, although it was important and is important to address that problem.

Now the fact of the matter is, Mr. Chairman, as you well know, that the foreign exchange market trades something like $175 billion in dollars every day. Some people estimate that only 3 percent of those transactions are trade related, some 97 percent being related to other factors.

So the point you make I think is absolutely valid.

Senator **Sarbanes**. I want to commend you for coming to grips with the problem in a practical and pragmatic way. That was a welcome change in the leadership in the Treasury Department. I'm not sure for the Nation that the personnel shift that took place to accomplish it was all that much to the Nation's advantage. You're not suppose to comment on that, Mr. Secretary, but we do appreciate the pragmatism you've brought to the responsibilities of the office and I think you're trying to come to grips with some very difficult problems in an effective way.

Do you have any closing comments, Congressman McMillan?

Representative **McMillan**. I would simply like to thank you Mr. Secretary, for a very interesting and informative session. I agree with you, we've debated in here some this morning what the realistic real growth rate is; we perhaps debated as to whether or not a tax increase is a solution to the problem.

But as one final question, would you care to take a minute to say what you think the impact would be, regardless of what the growth rate is and regardless of whether or not any action is taken on additional taxes—what abandonment of a discipline like Gramm-Rudman would signal to the country?

Secretary **Baker**. Well, I think I alluded earlier, Congressman McMillan, to the fact that I think it would be unfortunate if we abandoned Gramm-Rudman because I think it exerts a discipline, particularly on the possibility of additional spending, and I think it would be, therefore, unfortunate. The administration—we honestly feel like we have met that 108 target. We can differ with respect to whether our 3.2 is a better estimate than 2.8 or 2.9, but that's not going to make a whole lot of difference.

We can also, I suppose debate whether or not there's room for any further programmatic cuts on the domestic side. We happen to think there is room. We have submitted a budget that is totally different from the budgets of past years where we have come up here with practically nothing on the revenue side and asked for extensive cuts in domestic spending. We now have a total budget deficit reduction package of $42 billion, we are asking for $18 billion in spending cuts and we're suggesting $22 billion in receipts.

Now we can argue over what the makeup of those revenue measures or receipts ought to be. I've said before, here this morning and in other testimony, the President is simply not going to accept a delay of the tax rate decreases or a general broad-based tax increase, but we, Mr. Chairman, in good faith have come up here and suggested $22 billion in revenues and we would certainly hope that the Congress would take a realistic hard look at those proposals. You may have a bias against user fees for one reason or another, but the fact of the matter is, those are deficit reduction measures on the revenue side.

Senator **Sarbanes**. Senator Melcher, do you have anything else?

Senator **Melcher**. No, Mr. Chairman.

Senator **Sarbanes**. Mr. Secretary, as usual, you've been a very strong and effective witness. We thank you very much for coming.

The meeting on Monday, I would announce, with Chairman Volcker will be downstairs in SD-106. The hearing is recessed.

[Whereupon, at 12:10 p.m., the committee recessed, to reconvene at 10 a.m., Monday, February 2, 1987.]

THE 1987 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 2, 1987

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to recess, at 10 a.m., in room SD-106, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes, Proxmire, Melcher, and Symms; and Representatives Scheuer, Fish, and McMillan.

Also present: William R. Buechner, professional staff member.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The committee will come to order. The Joint Economic Committee is continuing its hearings on the annual Economic Report of the President in preparation for the JEC itself preparing its annual report.

We are pleased to have the opportunity to hear this morning from Paul Volcker, the Chairman of the Board of Governors of the Federal Reserve System.

Mr. Chairman, we're pleased to have you back before the committee. There's been a long-standing, positive, and constructive relationship between the Joint Economic Committee and the Federal Reserve and in particular with you as its Chairman. We are glad to have you back before the committee this morning and we look forward to hearing your testimony.

Before we proceed I would like to say that Senator D'Amato has left word that he is unable to attend the hearing today. He has requested that his opening statement be included in the record; and without objection, so ordered.

[The written opening statement of Senator D'Amato follows:]

WRITTEN OPENING STATEMENT OF SENATOR D'AMATO

MR. CHAIRMAN, I WANT TO WELCOME TO THE JOINT ECONOMIC COMMITTEE THIS MORNING OUR DISTINGUISHED CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE, PAUL VOLCKER. I LOOK FORWARD TO YOUR COMMENTS ON THE ECONOMIC OUTLOOK AND THE ADMINISTRATION'S ECONOMIC POLICIES FOR 1987.

SINCE TAKING OFFICE IN 1981, PRESIDENT REAGAN HAS EMPHASIZED THE IMPORTANCE OF PROMOTING REAL ECONOMIC GROWTH WITHIN AN ENVIRONMENT OF LONG-RUN PRICE STABILITY. WITH A CONTINUATION OF SLOWER THAN EXPECTED ECONOMIC GROWTH, MODERATE INFLATION, AND SERIOUS STRESS IN SOME SECTORS OF THE ECONOMY, THE DANGERS OF A MONETARY RESTRICTION OF ECONOMIC ACTIVITY ARE REAL AND IMPORTANT. GIVEN THE ECONOMIC DISLOCATION ASSOCIATED WITH THE RISE OF INFLATION IN THE 1970'S AND ITS REDUCTION IN 1981-1982, THE NATION ALSO CANNOT AFFORD TO IGNORE THE DANGERS OF ALLOWING A REACCELERATION OF INFLATION AND THE INEVITABLE ECONOMIC COST OF DISINFLATION.

WITH ALL OF THIS IN MIND, WE MUST CONTINUE TO GIVE SERIOUS ATTENTION TO THE MOUNTING FEDERAL BUDGET DEFICIT.

THE PRESIDENT'S COMMITMENT TO KEEP TAXES LOW AND TO REDUCE FEDERAL SPENDING SHOULD CONTINUE TO CONTRIBUTE TO ECONOMIC GROWTH BY FREEING RESOURCES THAT WOULD HAVE BEEN USED BY THE FEDERAL GOVERNMENT FOR MORE EFFICIENT USE BY THE PRIVATE SECTOR.

I LOOK FORWARD TO THE COMMENTS OF OUR DISTINGUISHED WITNESS, AND HOPE THAT HE CAN PROVIDE SOME INSIGHT INTO THE FEDERAL RESERVE'S MONETARY POLICY AND HOW IT WILL AFFECT THE ECONOMIC OUTLOOK FOR 1987.

THANK YOU, MR. CHAIRMAN.

Senator SARBANES. Mr. Chairman, please proceed.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman. As you know, I will be appearing before the Banking Committee shortly to discuss monetary policy in some detail, so I am going to confine myself today to more general considerations of domestic and international economic policies.

You also know the economy is now in the 5th year of expansion. It's among the longest of our expansions in history and there's been a big increase in employment. Unemployment is down. Real income of households is rising. After-tax profits have recovered and interest rates, in contrast to the usual cyclical pattern, are lower today than when the expansion started.

These are substantial economic gains and it's very significant to me and I think these gains are dependent upon the fact that we have also made consistent progress toward the overall objective of price stability.

Consumer prices rose only 1.1 percent last year and producer prices actually declined and we haven't seen a performance like that since the early 1960's.

Now we do know that that price performance reflected in large measure the transitory influence of the sharp drop in oil prices that occurred early last year and that movement has been partially reversed recently. Moreover, given the size of the fall in dollar exchange rates against other leading industrialized countries, increases in some important import prices are occurring. Because of those factors, we cannot reasonably expect so satisfactory a statistical result in 1987. There is, however, encouraging evidence of continuing restraint on costs and in pricing behavior. Most significantly, the trend toward moderation in nominal wage and salary increases has continued in almost all sectors of the economy and productivity gains in manufacturing—if not in other sectors—have been sizable during this expansion.

My purpose, however, is not to express satisfaction or any complacency over past performance. What will count is whether we can build upon and sustain that progress. And the obstacles and roadblocks are very evident.

You are all too familiar with regional and sectoral disparities in performance. Manufacturing has been relatively sluggish for 2 years or more. Much of agriculture is depressed despite massive Federal assistance. The energy industry has been hard hit. Conversely, employment in services and finance has been rapidly expanding.

Overall, it is higher levels of consumption that have been driving the economy over the past 2 years, while investment and domestic savings have lagged. That is hardly a sustainable combination. The exuberance of financial markets and the rapid pace of debt creation have been accompanied by evident pressures on some sectors of the financial system, rising loan losses, and the risks implied by greater leveraging of many businesses.

Plainly, in their particulars, many of the strains and imbalances in our economy can be traced to specific circumstances beyond the reach of broad fiscal or monetary policies. For instance, there is a worldwide tendency toward growing surpluses of basic agricultural commodities. The sharp break in oil prices has also been an international market event. Both of those circumstances have contributed to the strains of some lending institutions. But through it all, two disturbing and partly related currents run strongly—our trade and budget deficits. Those are matters that must be addressed—indeed, can only be constructively addressed—by appropriate national policies. And if we delay, the adjustments become even more difficult, compounding the risks for the future.

The direct effects of the trade deficit are clear enough. Burgeoning imports over several years, while exports in real terms have risen much more slowly, largely account for the overall sluggishness of manufacturing. With capacity ample, that sluggishness feeds back on spending for plant and equipment.

The effects of the budget deficit, in current circumstances, may be less obvious—after all, as many have noted, interest rates have fallen while the deficits have been so large, the huge new issues of Treasury securities have found a market, and private debt creation has been high as well. How is it possible when, to take one simple benchmark, our Federal deficit has averaged about two-thirds of the net savings generated by our economy over the past 4 years?

In effect, the answer is that we are drawing on the savings of others—in 1986, the net influx of foreign capital appears to have exceeded all the savings generated by individuals in the United States. That capital influx is the mirror image of the deficit in our current account. We cannot, at one and the same time, borrow abroad (net) to cover a domestic investment-savings imbalance and run a balanced current account.

In a sense—I think a limited sense—we have been fortunate. We have been able to increase consumption rather rapidly, sustain overall growth and reduce inflation and interest rates even in the face of a large Federal budget deficit by calling upon other nations' savings, which they have readily provided. But the cost has been a rising trade deficit and increasing international indebtedness, strong pressures on manufacturing in the here and now, and an unsustainable pattern of economic activity for the future fraught with political as well as economic risks.

Stated simply, we are living beyond our means—individuals, businesses, and government have been collectively spending more than we produce. That might be acceptable if we were matching the foreign borrowing with a surge in productive investment in the United States. That's been the case at times in the distant past in the United States and in other countries more recently. But we are not making that match now. It's consumption that's been leading the economic parade.

In that context, the challenge for economic policy over the next few years is clear enough. We have to work toward better external and internal balance at the same time. The adjustments required are large. Given our extended position, the difficulties and risks are substantial. We don't want to achieve the needed external adjustments by recession nor can we reasonably float off our debts by rekindling inflation—and I don't think it's realistic to think we have the option of trading one of those possibilities for the other.

All that may sound like abstractions. I will try to be more specific.

One requirement is progress in reducing our trade deficit. That, on the face of it, will bring benefits to manufacturing in the United States. The potential is huge—to close our $150 billion trade deficit by increased manufacturing (and I don't see any other practical avenue) implies a 15 to 20 percent increase in industrial output over the coming years above and beyond that required to support domestic growth. While a surge of that kind would be welcome in many respects, the challenge is to achieve it without renewed inflationary pressure in that sector. That will require continuing restraint on costs, more modernization, and in time more capacity, while in turn will require both money and real resources.

By definition, as we close the current account deficit, those funds and real resources will no longer be available from abroad. So we will have to increase our own savings or reduce other demands on savings at home. The obvious candidate—again, as a practical matter, it must be the largest "contributor"—is a reduction in our Federal budget deficit. And, unless productivity in the economy as a whole is to dramatically increase above the recent trend of 1 percent or so—and unhappily there is no evidence for that—we will not be able to close the gap in trade and meet our domestic investment needs without slowing the growth in domestic consumption well below the 4 percent pace it has averaged during the current expansion.

In concept, all those things are "doable." They provide the outline of an appropriate economic strategy. The result would be a more balanced economy, greatly enhancing the prospects for sustained growth and greater exchange rate and financial stability.

In fact, I believe we are beginning to make progress in the required directions. But in a sense, we have so far only set the stage. Many difficult decisions lie ahead.

In the current fiscal year, some significant progress toward reducing the extraordinary budget deficit appears to be underway. But as you well know, sustaining that progress will require still more difficult decisions this year, and for the years beyond. The Gramm-Rudman-Hollings targets have signaled your intentions, but more important than those numerical targets is specific action by the Congress to ensure that the deficit will in fact continue to decline year by year. Without that progress, it's difficult to see how we could manage to reduce the trade deficit—and with it the net capital flow from abroad—without jeopardizing growth, progress toward lower interest rates, and financial and price stability at home.

The large realignment of exchange rates over the past 2 years should enable our industry to compete much more aggressively with other major industrialized countries. But that constructive development should not obscure the fact that a declining dollar at some point has high costs and risks as well. It generates inflationary pressures. Uncertainties about the future direction of currency values could dampen the willingness of others to place or maintain funds in the United States—funds upon which, for the time being, we are utterly dependent to finance internal needs.

A self-generating cumulative process of currency depreciation and inflation serves no one's interest. Economic history is littered with examples of countries that acted as if currency depreciation alone could substitute for other action to restore balance and competitiveness to their economies.

That history emphasizes the need for national policy to remain strongly oriented toward maintaining greater price stability. As I indicated earlier, the good performance of the key price indexes in 1986 probably can't be matched this year as we absorb higher import prices and oil prices no longer fall. But monetary policy, in particular, must remain alert to the need to avoid any sense of cumulating inflationary pressures.

Over the past year or more, as inflation has subsided and with limited economic growth, the Federal Reserve has been able to accommodate a rapid growth in money and the discount rate has been reduced on several occasions. Clearly, renewed inflationary pressures and weakness in the dollar externally would be factors limiting our flexibility. In that context, your efforts to deal with the budget deficit are even more central to the financial and economic outlook.

In the end, the efficiency, competitiveness, and salesmanship of U.S. industry, and its ability to resist cost pressures, will be critical. As I indicated earlier, there are encouraging signs of improved productivity in manufacturing. As a result, profits and cash-flow have been reasonably well maintained even as prices of goods have remained virtually stable.

All that has been achieved during a period of intense competitive pressure from abroad and at a time of little growth in manufacturing. The challenge will be to maintain that performance as prices of competitive imports increase, as export markets improve, and as new needs for capacity arise. If not, the gains from the realignment of currencies could easily be frittered away.

The point has often been made that despite the longer run benefits for the economy as a whole, recent tax changes may tend to inhibit plant and equipment spending in some industries. On the other hand, the buoyancy of the financial markets should reduce the cost of capital and provide fresh opportunities for consolidating financial resources and balance sheet strength. Those opportunities should be used constructively and not be dissipated in excessive leveraging and financial risk taking that could in the end jeopardize our stability.

The burden of my comments is that there are gross distortions and imbalances in the economy that we must deal with forcibly and effectively. But we also have a lot upon which to build. The outlines of an effective approach are clear enough. Major elements of that approach are in place. But we will also need time and patience—and they are in short supply.

For instance, the deterioration in our trade balance appears to have ended, but signs that the corner has been turned are not yet decisive. Meanwhile, the inevitable adjustments in the energy industry, in agriculture, and in commercial building are continuing to work against economic growth in many areas. In these circumstances, stronger growth in 1987, as well as more sustainable growth over time, is heavily dependent on realization of significant gains in trade.

One temptation is to try to speed that process—and to vent our understandable frustration about restrictive trade policies of others—by resorting to broad-brush protectionism. But such a course, it seems to me, would invite almost certain failure. The lesson of experience is that world trade and economic activity would be depressed together. Indeed, given the greater degree of economic and financial interdependence of nations today, the risks and potential losses are all the greater.

At the same time, that very interdependence means that we cannot be successful unless other countries are taking constructive complementary actions to maintain their own growth, to keep their markets open, and to deal with legitimate complaints of unfair trading practices.

The United States and its currency are a major force in the world economy and financial system. In that context, I can readily understand the concern expressed abroad about instability in the dollar exchange markets and about the potential impact on their own economies. At a time of rather sluggish growth among the main industrialized countries, abrupt further changes in the dollar could undercut business planning and investment. We in the United States obviously have nothing to gain—and a great deal to lose—from any interruption in growth abroad.

But it is equally obvious that the needed improvement in our trade position must be matched by others absorbing increased imports and facing stronger export competition—logically and constructively, those changes should be borne primarily by countries with huge external surpluses. For countries that have been dependent on large export surpluses to support growth, that poses difficult adjustment problems, the mirror image of our own. In those cases, the plain need is to encourage domestic growth, while also maintaining the kind of open markets and receptivity to imports that are a necessary part of achieving better international balance in a framework of world growth. Naturally, they, too, want to maintain and consolidate greater price stability. But with their currencies appreciated, the opportunity to do so consistent with more rapid growth will be enhanced by cheaper and more available imports.

Sometimes, and I think unfortunately, that need for complementary adjustment abroad is framed in political terms as a request for "help" by the United States to resolve our own problems. But what is at issue is not a narrow concept of help for us or any single country; rather, it is what is required to achieve, in an interdependent world, the sustainable world growth and stability we all want. In that respect, no country heavily dependent on trade can be an island. Sooner or later, the necessary adjustments in trade will be made. The issue is whether they will be made in an orderly way, in a framework of open markets and growth, or with excessive currency instability or protectionism or both.

Our own responsibilities in that connection, as I have outlined, are unmistakable. But those measures inevitably impact others, and a better international balance cannot be achieved, in the interests of the United States and its trading partners, without constructive complementary policies abroad.

Moreover, such responsibilities extend beyond the main industrialized countries to others, particularly in the Far East, that have achieved rapid growth largely by penetrating foreign markets open to them, most of all in the United States. To the extent some of those countries have large and growing external surpluses, the time has clearly come for them to open their markets more broadly. In doing so, the benefits of their growth to their own consumers will be enhanced, even as they contribute to easing the problems of worldwide adjustments.

I want to emphasize, too, that all these actions—by the United States, by other industrialized countries, and by certainly newly industrialized countries—are a necessary part of achieving the healthy economic environment essential for other developing countries to constructively deal with their problems. The heavily indebted countries, in particular, must be able to penetrate export markets outside of the United States.

What I have tried this morning to outline is the broad directions that I believe U.S. policy must take—is in fact taking—during 1987 and the years ahead. And I think there are signs as well that the need for complementary policies abroad is increasingly well understood.

Plainly, much more remains to be done. I do not underestimate the difficulties. Right now, our own growth is hesitant, and the indicators of economic activity abroad have not been entirely reassuring. The general ebullience of financial markets masks some strains and weaknesses that will need continuing attention. Despite the progress of the past, the cooperative effort to deal with the acute debt problems in Latin America by the countries themselves, by the international financial institutions, and by leading banks needs fresh impetus. With oil and commodity prices now stable or even rising, maintaining the sense of progress toward general price stability will be more difficult, particularly in the United States. Needed policy changes, here and abroad, even when accepted conceptually, are hard to implement with the needed vigor.

At the same time, I think we should be encouraged by the degree to which some of the needed policies are in place. There is some evidence that the needed economic adjustments are beginning. What seems to me important, as we assess progress in 1987, is not so much whether we in the United States—at least within some reasonable range—reach some specific rate of overall economic growth. Rather, our emphasis in policymaking should be on whether the necessary adjustments are clearly underway and will in fact be sustained.

We won't eliminate the budget deficit or the trade deficit easily or quickly and certainly not in 1987. By the same token, we cannot expect to achieve an appropriate balance in our internal savings and investment in so short a period of time nor sharply improve productivity. As a practical matter, a sudden spurt in growth abroad won't be a solvent for our problems.

What we collectively can do—and what we must do—is act with force and conviction in the necessary directions. In doing so we will lay the base for sustained noninflationary growth not just in 1987 but for the years beyond.

[The prepared statement of Mr. Volcker follows:]

PREPARED STATEMENT OF HON. PAUL A. VOLCKER

I am pleased to appear once again before this Committee to discuss the economic situation. As you know, the Federal Reserve will be submitting its semi-annual report on monetary policy to Congress later this month. My testimony at that time will provide a full account of recent monetary developments and will report on the decisions to be made by the Federal Open Market Committee regarding money and credit targets for 1987. Therefore, in my statement today I will be emphasizing more general considerations of domestic and international economic policies.

The economy is now in the fifth year of expansion, making it among the longest. During this time about 11-1/2 million jobs have been created, and the unemployment rate has fallen more than 4 percentage points from its peak in 1982, reaching 6-3/4 percent in December. In contrast to the experience of the 1970s, real incomes of households have risen steadily in recent years. In the business sector, after tax profits have recovered both absolutely and relative to overall GNP. Interest rates, in contrast to the usual cyclical pattern, are lower today than when the expansion started.

These substantial economic gains were accompanied by -- and I believe fundamentally dependent upon -- consistent progress toward the objective of overall price stability. Consumer prices rose a scant 1.1 percent last year and producer prices actually declined -- a performance unrivaled since the early 1960s.

We know, of course, that that extraordinary progress reflected, in large measure, the transitory influence of the sharp drop in oil prices that occurred early last year; that movement has been partially reversed recently. Moreover, given the size of the fall in dollar exchange rates against other leading industrialized countries, increases in some important import prices are occurring. Because of those factors, we cannot reasonably expect so satisfactory a statistical result in 1987. There is, however, encouraging evidence of continuing restraint on costs and in pricing behavior. Most significantly, the trend toward moderation in nominal wage and salary increases has continued in almost all sectors of the economy and productivity gains in manufacturing (if not in other sectors) have been sizable during the expansion.

My purpose, however, is not to express satisfaction or complacency over past performance. What will count is whether we can build upon and sustain that progress. And the obstacles and roadblocks are evident.

You are all too familiar with regional and sectoral disparities in performance. Manufacturing has been relatively sluggish for two years or more. Much of agriculture is depressed despite massive federal assistance. The energy industry has been hard hit. Conversely, employment in services and finance has been rapidly expanding.

Overall, it is higher levels of consumption that have been driving the economy over the past two years, while investment and domestic savings have lagged, hardly a sustainable combination.

The exuberance of financial markets and the rapid pace of debt creation have been accompanied by evident pressures on some sectors of the financial system, rising loan losses, and the risks implied by greater leveraging of many businesses.

Plainly, in their particulars, many of the strains and imbalances in our economy can be traced to specific circumstances beyond the reach of broad fiscal or monetary policies. For instance, there is a worldwide tendency toward growing surpluses of basic agricultural commodities. The sharp break in oil prices has also been an international market event. Both of those circumstances have contributed to the strains on some lending institutions. But through it all, two disturbing (and partly related) currents run strongly -- our trade and budget deficits. Those are matters that must be addressed -- indeed can only be constructively addressed -- by appropriate national policies. And if we delay, the adjustments become even more difficult, compounding the risks for the future.

The direct effects of the trade deficit are clear enough. Burgeoning imports over several years, while exports in real terms have risen much more slowly, largely account for the overall sluggishness of manufacturing. With capacity ample, that sluggishness feeds back on spending for plant and equipment.

The effects of the budget deficit, in current circumstances, may be less obvious -- after all, as many have noted, interest rates have fallen while the deficits have been so large, the huge new issues of Treasury securities have found a market, and private debt creation has been high as well. How is that possible when, to take one simple benchmark, our federal deficit has averaged about two-thirds of the net savings generated by our economy over the past four years?

In effect, the answer is that we are drawing on the savings of others -- in 1986, the net influx of foreign capital appears to have exceeded all the savings generated by individuals in the United States. That capital influx is the mirror image of the deficit in our current account -- we cannot, at one and the same time, borrow abroad (net) to cover a domestic investment-savings imbalance and run a balanced current account.

In a sense we have been fortunate. We have been able to increase consumption rather rapidly, sustain overall growth and reduce inflation and interest rates even in the face of a large federal budget deficit by calling upon other nations' savings -- which they have readily provided. But the cost has been a rising trade deficit and increasing international indebtedness, strong pressures on manufacturing in the here and now, and an unsustainable pattern of economic activity for the future fraught with political as well as economic risks.

Stated simply, we are living beyond our means -- individuals, businesses, and government have collectively been spending more than we produce. That might be acceptable if we were matching the foreign borrowing with a surge in productive investment in the United States. That's been the case at times in the distant past in the United States and in other countries more recently. But we are not making that match now -- it's consumption that's been leading the economic parade.

In that context, the challenge for economic policy over the next few years is clear enough. We have to work toward better external and internal balance at the same time. The adjustments required are large. Given our extended position, the difficulties and risks are substantial. We don't want to achieve the needed external adjustments by recession nor can we reasonably float off our debts by rekindling inflation -- and I don't think it's realistic to think we have the option of trading one of those possibilities for the other.

That may sound like abstractions. I will be more specific.

One requirement is progress in reducing our trade deficit. That, on the face of it, will bring benefits to manufacturing in the United States. The potential is huge -- to close our $150 billion trade deficit by increased manufacturing (and I don't see any other practical avenue) implies a 15 to 20 percent increase in industrial output over the coming years above and beyond that required to support domestic growth.

While a surge of that kind would be welcome in many respects, the challenge is to achieve it without renewed inflationary pressure in that sector. That will require continuing restraint on costs, more modernization, and in time more capacity, which in turn will require both money and real resources.

By definition, as we close the current account deficit, those funds and real resources will no longer be available from abroad. So we will have to increase our own savings or reduce other demands on savings at home. The obvious candidate -- again, as a practical matter, it must be the largest "contributor" -- is a reduction in our federal budget deficit. And, unless productivity in the economy as a whole is to dramatically increase above the recent trend of 1% or so -- and unhappily there is no solid evidence for that -- we will not be able to close the gap in trade and meet our domestic investment needs without slowing the growth in domestic consumption well below the 4% pace it has averaged during the current expansion.

In concept, all those things are "doable." They provide the outline of an appropriate economic strategy. The result would be a more balanced economy, greatly enhancing the prospects for sustained growth and greater exchange rate and financial stability.

In fact, I believe we are beginning to make progress in the required directions. But in a sense, we have so far only set the stage. Many difficult decisions lie ahead.

-- In the current fiscal year, some significant progress toward reducing the extraordinary budget deficit appears to be underway. But as you well know, sustaining that progress will require still more difficult decisions this year, and for the years beyond. The Gramm-Rudman-Hollings targets have signaled your intentions, but more important than those numerical targets is specific action by the Congress to ensure that the deficit will in fact continue to decline year by year.

Without that progress, it's difficult to see how we could manage to reduce the trade deficit -- and with it the net capital flow from abroad -- without jeopardizing growth, progress toward lower interest rates, and financial and price stability at home.

-- The large realignment of exchange rates over the past two years should enable our industry to compete much more aggressively with other major industrialized countries. But that constructive development should not obscure the fact that a declining dollar at some point has high costs and risks as well. It generates inflationary pressures. Uncertainties about the future direction of currency values could dampen the willingness of others to place or maintain funds in the United States -- funds upon which, for the time being, we are utterly dependent to finance internal needs.

A self-generating cumulative process of currency depreciation and inflation serves no one's interest. Economic history is littered with examples of countries that acted as if currency depreciation alone could substitute for other action to restore balance and competitiveness to their economies.

-- That history emphasizes the need for national policy to remain strongly oriented toward maintaining greater price stability. As I indicated earlier, the good performance of the key price indices in 1986 probably can't be matched this year as we absorb higher import prices and oil prices no longer fall. But monetary policy, in particular, must remain alert to the need to avoid any sense of cumulating inflationary pressures.

Over the past year or more, as inflation has subsided and with limited economic growth, the Federal Reserve has been able to accommodate a rapid growth in money and the discount rate has been reduced on several occasions. Clearly, renewed inflationary pressures and weakness in the dollar externally would be factors limiting our flexibility. In that context, your efforts to deal with the budget deficit are even more central to the financial and economic outlook.

-- In the end, the efficiency, competitiveness, and salesmanship of U.S. industry, and its ability to resist cost increases, will be critical. As I indicated earlier, there are encouraging signs of improved productivity in manufacturing. As a result, profits and cash flow have been reasonably well maintained even as prices of goods have remained virtually stable.

All that has been achieved during a period of intense competitive pressure from abroad and at a time of little growth. The challenge will be to maintain that performance as prices of competitive imports increase, as export markets improve, and as new needs for capacity arise. If not, the gains from the realignment of currencies will be frittered away.

The point has often been made that despite the longer-run benefits for the economy as a whole, recent tax changes may tend to inhibit plant and equipment spending in some industries. On the other hand, the buoyancy of the financial markets should reduce the cost of capital and provide fresh opportunities for consolidating financial resources and balance sheet strength. Those opportunities should be used constructively and not be dissipated in excessive leveraging and financial risk-taking that could in the end jeopardize our stability.

The burden of my comments is that there are gross distortions and imbalances in the economy that we must deal with forcibly and effectively. But we also have a lot upon which to build. The outlines of an effective approach are clear enough. Major elements of that approach are in place. But we will also need time and patience -- and they are in short supply.

For instance, the deterioration in our trade balance appears to have ended, but signs that the corner has been turned are not yet decisive. Meanwhile, the inevitable adjustments in the energy industry, in agriculture, and in commercial building are continuing to work against economic growth in many areas. In these circumstances, stronger growth in 1987, as well as more sustainable growth over time, is heavily dependent on realization of significant gains in trade.

One temptation is to try to speed that process -- and to vent our understandable frustration about restrictive trade policies of others -- by resorting to broad-brush protectionism. But such a course, it seems to me, would invite almost certain failure. The lesson of experience is that world trade and economic activity would be depressed together. Indeed, given the greater degree of economic and financial interdependence of nations today, the risks and potential losses are all the greater.

At the same time, that very interdependence means that we cannot be successful unless other countries are taking constructive complementary actions to maintain their own growth, to keep their markets open, and to deal with legitimate complaints of unfair trading practices.

The United States and its currency are a major force in the world economy and financial system. In that context, I can readily understand the concern expressed abroad about instability in the dollar exchange markets and about the potential impact on their own economies. At a time of rather sluggish growth among the main industrialized countries, abrupt further changes in the dollar could undercut business planning and investment. We in the United States obviously have nothing to gain -- and a great deal to lose -- from any interruption in growth abroad.

But it is equally obvious that the needed improvement in our trade position must be matched by others absorbing increased imports and facing stronger export competition -- logically and constructively, those changes should be borne primarily by countries with huge external surpluses. For countries that have been dependent on large export surpluses to support growth, that poses difficult adjustment problems, the mirror image of ours. In those cases, the plain need is to encourage domestic growth, while also maintaining the kind of open markets and receptivity to imports that are a necessary part of achieving better international balance in a framework of world growth. Naturally they, too, want to maintain and consolidate greater price stability. But with their currencies appreciated, the opportunity to do so consistent with more rapid growth will be enhanced by cheaper and more available imports.

Sometimes, and I think unfortunately, that need for complementary adjustment abroad is framed in political terms as a request for "help" by the United States to resolve our own problems. But what is at issue is not a narrow concept of help for us or any single country; rather it is what is required to achieve, in an interdependent world, the sustainable world growth and stability we all want. In that respect, no country heavily dependent on trade is an island. Sooner or later, the necessary adjustments in trade will be made. The issue is whether they will be made in an orderly way, in a framework of open markets and growth, or with excessive currency instability or protectionism or both.

Our own responsibilities in that connection, as I have outlined, are unmistakable. But those measures inevitably impact others, and a better international balance cannot be achieved, in the interests of the United States and its trading partners, without constructive complementary policies abroad.

Moreover, such responsibilities extend beyond the main industrialized countries to others, particularly in the Far East, that have achieved rapid growth largely by penetrating foreign markets open to them, most of all in the United States. To the extent some of those countries have large and growing external surpluses, the time has clearly come for them to open their markets more broadly. In doing so, the benefits of their growth to their own consumers will be enhanced, even as they contribute to easing the problems of worldwide adjustments.

I want to emphasize, too, that all these actions -- by the United States, by other industrialized countries, and by certain newly industrialized countries -- are a necessary part of achieving the healthy economic environment essential for other developing countries to constructively deal with their problems. The heavily indebted countries, in particular, must be able to penetrate export markets outside of the United States.

What I have tried this morning to outline is the broad directions that I believe U.S. policy must take -- is in fact taking -- during 1987 and the years ahead. And I think there are signs as well that the need for complementary policies abroad is increasingly well understood.

Plainly, much more remains to be done. I do not underestimate the difficulties. Right now, our own growth is hesitant, and the indicators of economic activity abroad have not been entirely reassuring. The general ebullience of financial markets masks some strains and weaknesses that will need continuing attention. Despite the progress of the past, the cooperative effort to deal with the acute debt problems in Latin America by the countries themselves, by the international financial institutions, and by leading banks needs fresh impetus.

With oil and commodity prices now stable or even rising, maintaining the sense of progress toward general price stability will be more difficult, particularly in the United States. Needed policy changes, here and abroad, even when accepted conceptually, are hard to implement with the needed vigor.

At the same time, I think we should be encouraged by the degree to which some of the needed policies are in place. There is some evidence that the needed economic adjustments are beginning. What seems to me important, as we assess progress in 1987, is not so much whether we in the United States -- at least within some reasonable range -- reach some specific rate of overall economic growth. Rather, our emphasis in policy-making should be on whether the necessary adjustments are clearly underway and will in fact be sustained.

We won't eliminate the budget deficit or the trade deficit easily or quickly and certainly not in 1987. By the same token, we cannot expect to achieve an appropriate balance in our internal savings and investment in so short a period of time nor sharply improve productivity. As a practical matter, a sudden spurt in growth abroad won't be a solvent for our problems.

What we collectively can do -- and what we must do -- is act with force and conviction in the necessary directions. In doing so we will lay the base for sustained noninflationary growth not just in 1987 but for years beyond.

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Senator **Sarbanes**. Thank you very much, Mr. Chairman, for, as usual, a very thoughtful statement.

I will say to the members of the committee that I think we will have a generous 5-minute rule the first round and then you can come back for a second and indeed a third round if necessary.

Mr. Chairman, I would like to pick up on your comment where you say, "That may sound like abstractions. I will be more specific." I would like to take some parts of your statement and try to make then even more specific.

First of all, you say, "We must remain alert to the need to avoid any sense of cumulating inflationary pressures."

Do you sense now that there are such cumulating inflationary pressures taking place in the economy?

Mr. **Volcker**. No, I would not say I sense that now. To the contrary, the inflation rate has been coming down and we got that exceptional break last year, of course, in the oil price that had a little artificial tinge to the rate of incline. But if one looks particularly in the most encouraging area is progressive restraint we have had on wage and salary increases we have had during this period of expansion, and in the manufacturing sector, combined with a pretty good productivity result, you have a sense of cumulating movements toward price stability.

Now my concern is when you get pressures this year, which are more or less inevitable from rising import prices and from the higher oil price, if that's maintained, than we had for a good part of last year, the Consumer Price Index won't look as good—can we avoid that feeding back into wage and other cost trends and building in cumulating inflationary pressures? That's what we have to avoid.

I don't see them today, but the danger is clearly out there unless we are careful.

Senator **Sarbanes**. Do I take that to mean that we should really try to take out of the inflationary figure the oil decline impact?

Mr. **Volcker**. Well, that's one way of doing it, yes.

Senator **Sarbanes**. So that your view would be that the inflationary rate could have been higher last year and it still would have been a satisfactory performance if it was higher simply because of not having the benefit of the drop in oil prices?

Mr. **Volcker**. Yes. If we hadn't had the benefit of the drop in oil prices, the inflation rate would have been—I haven't done the calculation just now—but it would have been, I presume, a percent or two higher and that still would have been consistent with a little progress but not nearly so much.

One of the problems in the inflationary area is quite clear. We have not found an effective answer to the service area where we don't have productivity increases. It's zilch basically, if one believes the figures, and you have had higher costs in that area. You have had more pressures on capacity in that area, although it's much more difficult to measure.

So while the inflationary momentum has been stilled substantially in the manufacturing area, it still persists in the service area, although we have made progress there as well, happily.

But the basic trend rate of inflation in medical services, in educational services, and elsewhere has remained quite strong.

Senator **Sarbanes**. You say in making reference to the large realignment of exchange rates, "But that constructive development should not obscure the fact that a declining dollar at some point has high costs and risks as well."

What is the point at which the declining dollar has high costs and risks?

Mr. **Volcker**. Well, I suppose there's no particular point at which it turns from benign and into danger.

Senator **Sarbanes**. Is it at that point now?

Mr. **Volcker**. Yes, I would think so. We have been fortunate in a sense in that much of the decline in the dollar exchange rate offset relatively recent strength and was not accompanied proportionately—it was accompanied to some degree but not accompanied anywhere near proportionately—with rising import prices.

But as we talk about danger of movements from the present level, you would get a much more complete passthrough I think into import prices and that's one sense that we are at a more dangerous point now.

Senator **Sarbanes**. You make reference to "abrupt further changes in the dollar." Do you anticipate such a development?

Mr. **Volcker**. I do not and I think it would be unfortunate. I don't anticipate it, but whether or not it will occur depends upon our policies here and elsewhere.

Senator **Sarbanes**. Do you think that the G–5 forum is the correct forum in which to address the currency questions and other economic questions?

Mr. **Volcker**. Well, it's clear that the G–5 involves the most important industrialized countries in the world and it is small enough so that sometimes you can effect a fuller and franker exchange of views and the opportunity for constructive decisionmaking there that is sometimes much more difficult in a very large forum.

Senator **Sarbanes**. Do you think those meetings then ought to be regularized or should we go through the spate of rumors that we are now experiencing as to whether there will even be such a meeting, for instance, and the reading of the tea leaves of whether or not a meeting is even held brings on?

Mr. **Volcker**. Well, to some degree, they are more or less regularized. There usually is a meeting at the time of the IMF meetings. There's usually a meeting in the spring and there's usually been a meeting in winter. This recent speculation obviously was brought about because of uneasiness about feelings in the exchange market in recent weeks.

I don't like to feel that we have to have emergency meetings. There are other ways of communicating other than having a physical meeting of the five members and I don't like to see those meetings become quite the event that they sometimes have become recently. I think they ought to take place routinely. I think they ought to take place quietly, which is a little difficult to do. I think they do serve a very useful purpose, but that doesn't mean that specific decisions have to arise out of each of those meetings. I think that's a great mistake, to feel that you can't meet without having a series of specific decisions. The time may or may not be ripe to have such decisions when those meetings are scheduled. If they are, fine. If they're not, they can still serve a useful purpose.

Senator **Sarbanes**. There's been considerable comment in the press that current policies could lead to a free fall of the dollar. Are you apprehensive of a development of that sort?

Mr. **Volcker**. Well, I'd put it this way. I think it is incumbent upon us to maintain policies, and be seen to be maintaining policies, that would not justify what you call a free fall. It's a matter of confidence. When we have as big deficits as we have, both externally and internally, you're in some jeopardy. And that is what makes it so urgent for us to be moving in the right direction. We can't cure those deficits overnight, but we can be seen to be moving in the right direction.

If we are seen to be moving in the right direction, then I think we have the basis for maintaining confidence.

Senator **Sarbanes**. Well, my time on my first round has expired. I will come back, Mr. Volcker. Thank you very much. Congressman McMillan.

Representative **McMillan**. Thank you, Mr. Chairman. Mr. Volcker, you have addressed the budget deficit obviously and the discipline that Gramm-Rudman in terms of expressing the intent of Congress adds to the process.

Assuming that we in this session of Congress meet that target and succeed in doing so through spending restraint rather than through tax rate increases, do you foresee that as producing a negative economic impact in this country?

Mr. **Volcker**. I perceive it as producing a positive economic impact, given the conditions that we are in. You normally think of a reduction in the budget deficit as having in the short run at least some negative impacts on economic activity, let's say under your assumption, from the reduced Government spending itself.

But when you're in the particular position that we're in and the size of that budget deficit almost compels external borrowing which builds up vulnerabilities in the economy, it seems to me the implication of reducing the deficit is favorable and it should be offset over a reasonable period of time in terms of its direct effect by improved external balances. And that's a much more sustainable pattern of economic activity.

Now there are limits as to how fast these adjustments can be made in the short run. If you theoretically could just cut the deficit in half or eliminate it this year, that would be moving so fast that you probably would produce some economic dislocations. But within a feasible range, I think anything that you're likely to do, as a practical matter, would not be too much.

Representative **McMillan**. Well, it has been asserted by some that the budget deficit is the reason for the economic progress that we've made over the past several years, that it is largely fueled by the deficit. Would you agree with that assertion?

Mr. **Volcker**. No, I don't think so, because it's provided some direct fuel but you have to look at what else was going on at the same time—are interest rates higher than they otherwise would be, and I think the answer to that is yes; is the trade deficit larger than it otherwise would be, and I think the answer to that is yes.

So we've got, in converse to what I was just saying, you get some direct stimulus from the budget deficit, but I would rather have seen the economy move forward in a more balanced way, in a way that's more sustainable. And the reason that we have some of these imbalances I think is because the budget deficit is so big.

Representative McMillan. Well, if I interpret what you're saying, if this Congress should—and I hope it does—succeed in meeting the deficit reduction target as set forth by Gramm-Rudman for 1987 without a tax rate increase, you would not foresee that having any negative economic impact? That would not be exceeding the limits that you referred to earlier?

Mr. Volcker. No. I can't imagine you exceeding the limits that I would have in mind in terms of budgetary progress and I think the result would be constructive.

Now you can get into questions of timing—would it have some initial impact of slowing the economy a little more than it might otherwise be for a quarter or two. That is not significant in my mind. What is significant is that you put the economy on a more sustainable course. And that means we've got to deal with this external deficit and dealing with that external deficit means dealing with the internal deficit.

The basic point is, we can't dispense with the external deficit and the financing that it implies unless we reduce the need for financing in the United States. And that's where the budget deficit comes in.

Representative McMillan. One final question in this first round. You've made reference to the ebullience of the financial markets. Would you care to comment as to what factors underlie that ebullience and what confidence we might have in those for the future?

Mr. Volcker. Well, I'm not sure I am competent to answer that question. You ought to get a securities analyst up here to tell you. But obviously the market is, to some degree, reflecting the fact that we have had 5 years of economic recovery. Profits have not been at record levels relative to the economy but they have recovered substantially relative to the economy. We have made a lot of progress on the inflation front. All those things point in a favorable direction.

I think the markets are not looking very hard at some of the more questionable aspects of current performance, including the substantial pressures on parts of the financial system. The assumption must be that we are going to deal with those.

Well, I think we can deal with them if we have a broad economic policy that's moving in the right direction. But there are clearly risks in that area and we see a lot of activity in financial markets that I don't think is particularly healthy. We've had a tremendous rate of debt expansion. We've had retirement of equity rather than the reverse. And I would hope one of the consequences of the stock market ebullience might be to reverse that clear tendency we've had toward greater leveraging. That is clearly a limited, nonsustainable process, too.

Representative McMillan. One little final question on that note. Do you think the tax reform package as passed will also tend to encourage the use of equity as opposed to debt?

Mr. Volcker. In a small way. The steps that were made in that direction are primarily I think from the reduction in tax rates itself. The way we tax corporations discourages the issuance of equity and favors the issuance of debt. That's been a structural characteristic of our tax system for some time. People seem to think it's more important now. You relieved it in the tax reform package almost entirely for the reason that marginal tax rates are reduced, but the advantage of issuing debt remains and you didn't take any more direct action such as dealing with nontaxability of dividends or integrating the individual and corporate tax rates that would go to the heart of that problem.

So I think that problem remains, although it's somewhat ameliorated.

Representative McMILLAN. Thank you, Mr. Chairman.

Senator SARBANES. Senator Melcher.

Senator MELCHER. Mr. Volcker, with the economic management we've had in this country for the past several years with a strong dollar, the commodity prices went down for agriculture for lack of exports. The commodity prices for minerals went down because of the minerals pouring in from other countries.

Now the options we have before us here in Congress on trade, the ones of significance in my view, are reciprocal agreements either bilateral or multilateral, or expanding exports.

Now you touched on these things in terms of manufacturing exports being increased. I want to speak a little about surplus agricultural commodities, expanding exports of those, those that we have in surplus here in the United States we should obviously attempt to export any way we can.

Now in this situation we are in right now, there's need for credit. The Farm Credit System is in jeopardy. You mentioned oil interest rates, but the interest rates for Farm Credit System borrowers are around 11 or 12 percent. That's not low.

Have you considered coming to the assistance of the Farm Credit System with loans at very low rates of interest compared to some of the high bonds they have? Have you considered that?

Mr. VOLCKER. Well, when you say "have we considered it," you mean the Federal Reserve explicitly?

Senator MELCHER. Yes.

Mr. VOLCKER. We have certain authority to lend to the Farm Credit System or parts of the Farm Credit System in response to liquidity needs, but that doesn't say anything about coming to long-term assistance with low interest rates. I don't think that's within our authority.

Senator MELCHER. You don't think you have the legal authority for that?

Mr. VOLCKER. No.

Senator MELCHER. Would you like it?

Mr. VOLCKER. No.

Senator MELCHER. Why?

Mr. VOLCKER. Because I don't think that's really the function of the Federal Reserve to engage in that kind of lending to particular sectors of the economy. If that kind of thing is good public policy, then I think the Government ought to do it directly and not through the central bank.

So I think that's an issue you could debate, but it doesn't seem to me an appropriate function for the central bank specifically as opposed to the Government generally.

Senator MELCHER. How about the FSLIC, aren't they going to need bailing out?

Mr. VOLCKER. Yes. I don't like to use that term, but it's going to need an injection of liquidity. That's for sure.

Senator MELCHER. Are you considering that?

Mr. VOLCKER. Yes. It is being considered by the administration and the Congress. That's not, again, directly our business, but there is a proposal for recapitalization of the FSLIC which is before the Banking Committees right now, and I think I don't know of any reasonable alternative to proceeding along that line at present. In the long run there would be other alternatives.

Senator MELCHER. On the Farm Credit System, would you consider it more inflationary for the Congress to increase the Federal deficit to whatever extent is needed to provide some stability to the Farm Credit System—would you consider Congress doing it on appropriations and thereby increasing the deficit, do you think that's more or less inflationary than giving enabling legislation to the Federal Reserve for it to do the same thing?

Mr. VOLCKER. Well, just picking out that single action in isolation and assuming everything else was changed, obviously the more money that is spent or the more credit that is injected by either avenue would be inflationary. It would be less inflationary for the Government to do it than if the Federal Reserve did it by increasing the money supply more than it would otherwise increase it.

If it was offset through other actions by the Federal Reserve, as a technical matter, the impact would be the same. But there is always the threat in the central bank that you do involve the money creation process in that kind of subsidy which I think is fundamentally a mistake and we should try to avoid any temptation to do that.

That's why I wouldn't like to see that authority in the Federal Reserve.

Senator MELCHER. Well, in both cases you increase the money supply, do we not?

Mr. VOLCKER. Well, it all depends.

Senator MELCHER. So it's a question of——

Mr. VOLCKER. It would be much less direct and the pressures would be less if it was done outside the Federal Reserve.

Senator MELCHER. So the question is, on inflation, it's about six of one and half a dozen of the other, because in both instances there has to be offsets, would there not?

Mr. VOLCKER. Yes, but I do think that once—if you begin adopting the policy of using the Federal Reserve for that kind of assistance, I think over time the dangers would be greater that you would convert the Federal Reserve into an engine for inflation and that is precisely what we want to avoid and why the Federal Reserve is set aside, so to speak, in the structure of government, because it can too easily become a money machine. And under those kinds of social pressures, the dangers would become greater.

So I think that kind of assistance should be put in the Treasury, if you're going to do it, rather than in the Federal Reserve. And the Federal Reserve ought to keep its eye on the ball of maintaining an appropriate growth in the money supply without being charged with that kind of responsibility.

Senator **Melcher**. Many people think that there will be a lowering of the discount rate within 60 days. Are they whistling in the dark?

Mr. **Volcker**. Markets speculate all the time and I'm not going to comment on that at all.

Senator **Melcher**. Whether it's whistling or not?

Mr. **Volcker**. Sometimes it's whistling and sometimes it's not, and I'm not going to comment.

Senator **Melcher**. No tune right now?

Mr. **Volcker**. The market goes through cycles of expectations one way or the other.

Senator **Sarbanes**. That sounds like a Casey Stengel-Yogi Berra type of answer.

Senator **Melcher**. Thank you, Mr. Chairman.

Senator **Sarbanes**. Senator Symms.

Senator **Symms**. Thank you very much, Mr. Chairman, and thank you, Chairman Volcker, for your willingness to appear before this committee today.

I think, as one member of the committee, that you have achieved a remarkable record as Chairman of the Federal Reserve when we consider what's happened with inflation, the international debt crisis, reductions in interest rates—setting the framework for this period of long, sustained economic growth that's happened in some parts of the country.

I want to say that it hasn't happened in all parts of the country. I think Senator Melcher and I come from a part of the country that's suffered greatly over these depressed commodity prices.

Mr. **Volcker**. No doubt about that.

Senator **Symms**. I want to go ahead and get into this question with you—the one thing that's really concerned me is that when you took over as Chairman of the Fed somewhere along about 1979, we had always had a steady velocity of M1 ratio to the GNP. Since you took over, the velocity of money has slowed down. We've had big increases in the volumetric amount of M1, but yet you have stabilized the economy and we've got the lowest inflation rate we've had in the last 25 years.

So I was wondering how did you do it and could you give us some words of wisdom or some theoretical insights for some future Federal Reserve Governor?

Mr. **Volcker**. Well, first of all, we didn't exactly plan or expect the decline in velocity that we've had over the past 3 years or so. That decline in velocity didn't begin in 1979, 1980, 1981, or 1982. Maybe it began in 1983 and certainly in 1984.

I think part of what you see here is an unwinding—a reversal of the tendency that was underway in the 1970's or even earlier running into the early 1980's, where you had an inflationary environment, increasingly inflationary environment, and an upward trend in interest rates. And those events led people to want to, in the jargon, economize in the use of money. You didn't want to hang onto money when you weren't getting paid much interest on money holdings. In those days it was even harder to get interest on your money when prices were rising and other interest rates were rising.

Now we've seen a reversal of that since 1982 or 1983. Interest rates are substantially lower. Because of institutional changes you can now get paid interest on money. There is less inflationary worry. All of that has given rise to more comfort in holding money and I think has permitted us to accommodate monetary growth that would have been wholly inappropriate in the 1970's or early 1980's, and would have been highly inflationary. In these circumstances it has not been.

Senator SYMMS. Well, could I just interject right there, with the free fall of the dollar, at what point do the people who are just sitting on their money in the bank or somewhere and keep it from having high velocity going to start losing confidence in the dollar and put it in something else?

Mr. VOLCKER. I think that is clearly a danger, whether one looks at it from the standpoint of the fall of the dollar externally or some sense that inflation is rearing its ugly head again internally, people lose complacency or confidence in holding money and they begin spending it. Then you would have an entirely different financial situation and these kinds of increases in the money supply that we've been having would be entirely inappropriate.

In those circumstances, we would certainly want to cut back on the rate of growth in money, maybe cut back on amount of money in absolute terms.

Senator SYMMS. Well, Mr. Chairman, I think my 5 minutes are about up, but just as a point of curiosity—and I think it is important for financial confidence and stability in the operations of the Federal Reserve—if President Reagan asks you to stay on as Chairman of the Fed, would you accept that position?

Mr. VOLCKER. I don't think I want to comment on that question this morning, Senator.

Senator SYMMS. I was afraid you might say that. Thank you very much, Chairman Volcker.

Senator SARBANES. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman. It's always a pleasure to have you back with us, Chairman Volcker.

You give us what has to be an alarming statistic there in your statement when you tell us that the net influx of foreign capital—that is, the amount that we're borrowing abroad—has exceeded all savings generated by individuals.

Mr. VOLCKER. All savings by individuals. I meant it to be alarming, Congressman Scheuer. But I just want to make sure you recognize that we also have business savings. But if one looks at personal savings, our capital inflow exceeds personal savings.

Representative SCHEUER. I know you read the article in this morning's Wall Street Journal on the left-hand side about the enormous growth in domestic debt, which I'm also sure intended to be alarming and I'm alarmed. You have succeeded in alarming me.

Then you give a prescription that we Americans have to save more and consume less. We have to increase savings and reduce other demands on savings at home, reduce our consumption of housing and automobiles that are supposedly the mainstay of the American economy. We live in houses and drive in cars that are astronomically large compared to the other developed nations of

Europe, Japan, Australia, New Zealand, whose standard of living by any reasonable test equals or exceeds ours.

How do we get the American people to save more and consume less?

Mr. **Volcker**. I think the only way you are going to do it as a practical matter is by reducing the Government deficit. That's part of the process. I don't think you have any reasonable basis for assuming that the American people are suddenly going to save a lot more. They haven't saved a lot more for 30 years and I don't think they are going to suddenly change their behavior this year or next year or whatever. It's been tending to go in the other direction.

What you can do is reduce the other side of it, the demand for those savings generated by the Government. You don't want to reduce business investment. We want to see more business investment.

I don't know as we have to have less housing than we've been having, but we have to have less something. And the obvious place where you can have a real impact and swing the balance is by reducing what the economists list as dissaving by the Government, or looked at from the other point of view, reduce the demands for savings caused by the Government deficit.

That Government deficit is broadly comparable in size to what we are borrowing from abroad. If we didn't have the Government deficit, we wouldn't have to borrow from abroad even with the current level of savings that we generate privately. And I think that is the only practical avenue of attack in the next few years. I'm not talking about 10 or 20 years from now, but we should recognize that we are not a high savings economy, never have been in recent years.

Representative **Scheuer**. Should we be offering our citizens some kind of incentive to save and to invest in the industrial sector that is in very fierce competition with global competitors?

Mr. **Volcker**. Well, you can argue that and——

Representative **Scheuer**. Excuse me. We took away their incentive to invest in shopping centers or a lot of the sort of artifical tax incentives——

Mr. **Volcker**. That's correct.

Representative **Scheuer**. To invest in high-rise arpartment houses, offices buildings, hotels, and shopping centers.

Mr. **Volcker**. Right.

Representative **Scheuer**. Now should we add an additional incremental incentive for them to invest in new productive manufacturing facilities of all kinds which is where we are in bitter global competition?

Mr. **Volcker**. Well, you took away some of those incentives, too—the investment tax credit, and change in depreciation and that, in the short run, probably works in the wrong direction. But that's, again, affecting incentives for investment. It doesn't do much to generate the funds for the investment. In a direct sense, investment tax credit generates the funds for businesses but it comes out of the Government's hide and unless you do something else on the budget it's a wash. It provides an incentive but it doesn't provide the savings.

So you've got to come back, I think, and deal with the deficit problem. Now you can argue you can provide incentives directly for savings and you did that and cut it back quite a lot with the Individual Retirement Accounts and so forth, but that did not have any demonstrable significant influence on the flow of savings and I think it's a demonstration of what I'm talking about. It's very hard to change those savings patterns and I would not encourage you to think that by, within what's practically possible, some tax gimmick of some sort or another you're going to have a really significant effect on the tendency of individuals or businesses in the United States to save.

Representative SCHEUER. Well, should we try and achieve some kind of national industrial policy to encourage savings and to encourage investment in this sphere of American industry?

Mr. VOLCKER. I would say, yes, you should have a national industrial policy to encourage savings. You do that by reducing the deficit.

Representative SCHEUER. Thank you, Mr. Chairman.

Senator SARBANES. I want to welcome Congressman Fish to the committee. I think this is the first opportunity for him to be with us. We are very pleased to have him join the Joint Economic Committee. I know he's going to be a very valuable member. Congressman Fish.

Representative FISH. Thank you very much, Mr. Chairman. Chairman Volcker, as a new member, when I sat down here I said to myself, "Well, I think I'll listen and pass up the opportunity," but I've overcome my inhibitions because you've been getting into so many interesting areas. So the chairman is going to have to remind me with his gavel when my time is up.

The fall in oil prices has been mentioned a couple of times today in the context of being beneficial with respect to the interest rates. It seems to me that it's also been devastating to the oil producing States' economies. It's resulted both in a reduction in domestic production I understand of around a million barrels a day. It's resulted in an increase in imports of about the same amount.

Together, these events mean a greater reliance on oil imports and that to me brings back a specter of a decade or 15 years ago and I wonder if you would like to comment on the danger of this and whether or not you see the low prices today as an opportunity perhaps to generate some revenue to bring down the deficit.

Mr. VOLCKER. Well, I think there is a danger of the kind that you describe and, as you say, you can see that tendency at work. Our imports are increasing in volume terms and I fear that that tendency will continue for some time, which is one of the reasons just incidentally I believe the trade balance is going to have to be resolved by manufactured goods rather than either in agriculture or in the energy area. The energy balance will probably get worse, not better. I would say if you were going to raise revenues, that's an obvious place to look.

Representative FISH. Thank you. You've made your position quite clear in your prepared statement against protectionism. As you know, it's going to be a major consideration by this Congress. It's almost certain that we will adopt trade legislation to address what's developed in recent years with the growth of U.S. imports greatly exceeding our exports.

So while we have you here, would you like to elaborate further as to what would be the impact on our economy if we do produce legislation to protect domestic manufacturing?

Mr. VOLCKER. Well, it's difficult to answer that question without describing a little more what you are intending to do. But if you mean a general protectionist measure, broad-scale quotas, sharp increase in tariffs, that kind of thing—I think the effects on our economy would be sharply adverse and those effects would be so adverse partly because in being adverse for foreign economies that would feed back on us. To the extent—and I think it's almost certain—it would provoke some retaliation, then you have a direct adverse effect on our exporters and I think the great danger is that in a situation in which the world economy is not growing very strongly anyway—not just in the United States but elsewhere—in fact, our growth rate has been higher than in other countries, even though in some ways they are in a much stronger position—nonetheless, our growth rate has been higher, particularly our internal growth rate until very recently. You have the real risk of catapulting the world into a recession.

Representative FISH. As a New Yorker, I was interested in reading over the weekend that the New York Federal Reserve has had a proposal to restructure the U.S. financial industry, including banking, insurance, and securities. The press reports that you are receptive to this and I would ask you if you would care to elaborate on this and what are the domestic and global implications, what regulatory changes would accompany changing the financial industry?

Mr. VOLCKER. Well, I don't know how much you want me to elaborate on it, but I would be glad to. And I think it's particularly apropos because Congress has before it now, at least in the Senate Banking Committee, some limited steps that would lay some of the foundation stones for a much more comprehensive review that's necessary.

But we have argued for some time for an expansion and rationalization of the powers of bank holding companies, at the same time recognizing that there is something special about banking in this country that requires protection, support, and regulation. And we believe very firmly—and it was argued very arguably in the New York Federal Reserve Bank's report—that we should have a general division between general business, commerce, and banking. And then the question becomes as to how you specifically set that borderline and to what extent it is appropriate for bank holding companies, including banks, to engage in more financial activities than they have been able to engage in in recent years.

Now the issue that's right on the table now is what securities powers, and there are certain securities powers that we have advocated for years, and I think Congress should now take that step of providing certain additional securities powers.

Corporate underwriting is a much more controversial issue and I wish Congress would review that because changes are taking place in the marketplace and I think we've got a little more time, but we ought to come to an intelligent judgment.

There are areas of financial services such as insurance brokerage, real estate brokerage—there's a question whether that's a financial service, but that's a borderline service—that we think banks and bank holding companies could usefully perform.

When you get into the commercial area, and we see companies trying to do this every day right now through the device of a so-called nonbank bank, we think you're asking for a lot of trouble. They are very limited today, but as a precedent for huge financial banking-commerce conglomerates I think it moves in clearly a different direction than our whole tradition has indicated and a direction that would not be healthy for either the financial system or the economy or the American consumer, and I think that ought to be resisted and basically that's what this whole argument about nonbank banks is about.

I would urge Congress to shut off that avenue, particularly so far as it involves combinations of banking and commerce, as quickly as it can.

Representative **Fish**. Thank you, Mr. Chairman.

Senator **Sarbanes**. Senator Proxmire.

Senator **Proxmire**. Thank you, Mr. Chairman. Chairman Volcker, it's always great to see you whether it's before the Banking Committee or before the Joint Economic Committee.

Mr. **Volcker**. I didn't realize we were going to be discussing your bill here.

Senator **Proxmire**. Well, I'm not going to be discussing it. We'll have plenty of time to do that a little later on.

I'd like to discuss your prepared statement. On the first page, you say "The economy is now in the fifth year of expansion, making it among the longest." I don't think any of us think we've repealed the business cycle. We're going to get a recession sometime. We don't know whether it will be this year or next year, but it's going to come.

You say "We are living beyond our means—individuals, businesses, and government have collectively been spending more than we produce."

Then you say "We will have to increase our own savings or reduce other demands on savings at home."

Now how do you respond to the argument that the Federal Reserve has helped greatly in putting us into this dilemma that we're in by following a policy of enormously increasing the money supply, more than 17 percent in 1986 at a time when the nominal GNP was only about 5 percent, and the Federal Reserve Board in doing this has encouraged individuals to borrow more money because, of course, the price of money is cheaper, discouraged people from saving money because they get less return on their savings from doing so, and is paving the way—while the short-term effects have been excellent, of course, in the long run, we are likely to be in a very serious dilemma with a colossal increase in debt which you, among others, have stressed in the past not only for the Federal Government but for the consumer which is $2.6 trillion, for the corporations which is over $3 trillion and rising?

Mr. **Volcker**. Well, let me answer the question this way. I think you are correct in the sense that simply pumping up the economy to what I would call excessive growth in money and credit—I'm not saying it has been excessive—but if one did that in the future, at the expense of aggravating these basic imbalances, you're not doing anybody a favor in terms of the ultimate result.

I don't believe that we have been doing that, but we get some advice which seems to amount to doing that.

What we would like to do is see the economy continuing to grow—and, as I say here, I don't think it's so critical at just what rate of speed it grows—relative to dealing with those imbalances that you're talking about.

But you've got to look to other tools to deal in an important way with those imbalances or we haven't got an answer to the present dilemma. But we do have other tools. We've got the tool of budgetary policy and that's got to move in the right direction. We have had the shift in exchange rates, a very important element in achieving international balance, and we've got the whole complex of questions involved in what kind of policies that other countries have to adopt or follow through on if we are to reduce those imbalances while maintaining growth at some level in the American economy.

That's what we ought to try to do and you simply can't do it with one instrument alone. If you try to maintain the growth through monetary policy and these other things are not operating correctly, you're right; that the imbalances would get worse rather than get better. So it's no answer to the problem. But when we have a combination of instruments, then I think we can work through it.

Senator **Proxmire**. But every single instrument that we have is working in the direction, it seems to me, of exploding the debt. People talk about we're making progress on the budget. Well, the fact is, 1986 was the year of the Deficit Reduction Act, the Gramm-Rudman-Hollings bill. We had the biggest deficit ever. It increased. It went to $221 billion. The first quarter of this year is over now. It started on October 1, and ended on December 31, and the deficit was $63 billion in that one quarter. That's an annual rate of $250 billion a year.

Then we look at monetary policy and, as I say, it's not as if it's just a little bit expensive; it's way out of sight.

Mr. **Volcker**. Well, now wait a minute. I'm not going to accept that, Senator.

Senator **Proxmire**. Well, on almost any basis. After all, when you have a 17 percent growth in M1 and you have a huge growth in M1 and M1 and you compare that with a nominal increase in the gross national product——

Mr. **Volcker**. M2 and M3 happened to end up the year within the target ranges.

Senator **Proxmire**. Sure, because of the drop in the inflation rate, the target ranges become excessive.

Mr. **Volcker**. Well, that's a matter of judgment. Again, the objective is to maintain some forward momentum in the economy consistent with progress against inflation, and we have to deal with those imbalances and you can't achieve all of those objectives at the same time through the single instrument of monetary policy.

Senator **Proxmire**. Now on page——

Mr. **Volcker**. But I think you are quite right in pointing out—I mean I accept the implication of your statement that there are limitations as to what monetary policy can and should do to simply maintain consumption and debt creation.

Senator **Proxmire**. Well, here's one Senator who thinks we've gone much too far in that respect now.

Now in your statement, you say "At the same time, that very interdependence means that we cannot be successful unless other countries are taking constructive complementary actions to maintain their own growth."

Are you telling other countries they should do the same thing? Are we telling them that they should also run huge deficits, that they should also have a monetary policy like ours? It seems to me we're asking for a worldwide crash like the 1930's depression.

Mr. **Volcker**. I think what we are suggesting to other countries that by and large have high savings rates, that are not employing their savings at home—just the mirror image of our situation—that if they could grow faster domestically, that will offset the decline in growth that will come from a deterioration in their trade balance, which is the reverse of the improvement that we want in our trade balance.

Senator **Proxmire**. I understand that, but I say how do they do it except by running deficits and having an expansive monetary policy which I think is irresponsible, but the kind we have?

Mr. **Volcker**. Well, relative to what they have now, it implies more expansive fiscal and monetary policies. I think that is correct. But where I would differ with you is as to whether that is irresponsible or not.

Senator **Proxmire**. Doesn't that lead in the long run almost inevitably to inflation. If we have an explosion of money which is three times the size of the nominal GNP in this country and ask other countries to do the same thing, aren't we looking forward to a world that is inflationary?

Mr. **Volcker**. Those other countries have to obviously choose their measures depending upon their internal circumstances, but I think they have room for more expansionary policies in terms of domestic growth to offset the deflationary effect of slower external growth. And because their currencies have appreciated so much, they have the opportunity to make some progress in that direction I think without the kind of inflationary concerns that you're suggesting.

In Japan and in Germany, for instance, wholesale prices are down sharply. Consumer price levels are practically unchanged. That doen't even reflect the full effects of their currency appreciation as yet. So the question is, how much room they have? That's a matter of judgment. But I think they have some room to expand domestic growth if the external stimulus is being withdrawn. Their growth rates are less than ours.

Senator **Proxmire**. Well, my time is up, Mr. Chairman.

Mr. **Volcker**. I don't think you can argue—just to finish this point—at least I wouldn't—that Germany and Japan are incapable of growing more than 2 percent a year, given the resources they have or more than 2.5 percent a year, and that's the outlook.

Senator **Proxmire**. Thank you, Mr. Chairman.

Senator **Sarbanes**. Would you say, Mr. Volcker, to follow up on that, that given the current strength of their economies, Germany and Japan are not carrying their international economic responsibilities, in terms of what they should be doing to sustain a proper movement in the world economy?

Mr. VOLCKER. Well, both of them have taken constructive actions in the appropriate direction it seems to me. Both of them have been experiencing more domestic growth as their external stimulus has gone down. So I don't want to criticize what they've been doing, but I think——

Senator SARBANES. Do you think they have done enough?

Mr. VOLCKER. Well, I wonder. And I would think both of them might find room for doing more constructively, yes. I think that is fair. But that's going to have to be a judgment they make. I think they understand the issue and we'll just wait and see whether they think further action is appropriate.

But I worry, yes. I worry that their growth momentum is in danger of being too little rather then too much. I guess it's the reverse of Senator Proxmire's worry.

Senator SARBANES. Let me continue this process of trying to divine the implications of some of your statements.

You say that we shouldn't "vent our understandable frustration about restrictive trade policies of others by resorting to broad-brush protectionism." Do you distinguish between "broad-brush protectionism" and narrowly pointed protectionism?

Mr. VOLCKER. I distinguish broad-brush protectionism and actions designed—although it's very tricky—to try to deal with specific trading practices like dumping.

Senator SARBANES. You mention unfair trading practices.

Mr. VOLCKER. Yes.

Senator SARBANES. Would you think actions designed to deal specifically with unfair trading practices would be reasonable and warranted on the part of the U.S. Government?

Mr. VOLCKER. To a degree, yes; but I think you get into a very tricky area here as to distinguishing between desirable aggressive, in one sense, actions to deal with unfair trading practices and a kind of straightforward protectionism. Unfair trading practices are in the eye of the beholder often, and other countries think we have a few, too.

Senator SARBANES. Do you think that the situation the United States is confronted with, with respect to trading practices, does not include a sufficient degree of unfair trading practices to the point that we need to do something about it?

Mr. VOLCKER. I'm not sure I understand.

Senator SARBANES. Do you think that there are not unfair trading practices which we are encountering that we need not do something about?

Mr. VOLCKER. I certainly think there are unfair trading practices that we encounter, whether directed specifically toward the United States—and some of them amount to that—or directed toward any imports.

But take the case of Taiwan, a small country running a huge surplus these days. And while I'm not expert in this area, my impression is they maintain a whole set of restrictive import practices. If they were ever justified back when you thought of Taiwan as a weak economic force and in deficit and borrowing, they are certainly not appropriate today. And whatever we can do to encourage them to reduce those practices I think is appropriate. Now that's picking on one particular country, but you could say that in greater or lesser degree about some other countries.

I don't think that Japanese market has been very open, to say the least. You can take in the agricultural areas that Senator Melcher is interested in, Japan imports wheat and some other things through Government trading organizations that have not permitted the lower price of those commodities, a lower price in dollars and a still lower price when you look at it in yen, to be reflected at all fully in their domestic market and it seems to me that's a restrictive trading practice.

Obviously, their agricultural protectionism is very deeply engrained, but it's there. It's not just agricultural protectionism. It goes through a lot of other industries.

Senator SARBANES. You say, "What seems to me important as we assess progress in 1987, is not so much whether we in the United States—at least within some reasonable range—reach some specific rate of overall economic growth. Rather, our emphasis in policymaking should be on whether the necessary adjustments are clearly underway and will in fact be sustained."

I want to get a better understanding of what that means in terms of a rate of overall economic growth. Would you entertain a downturn in the economy in order to achieve some of these necessary adjustments?

Mr. VOLCKER. That sentence is written in terms of rate of growth, not negative rates of growth. Obviously, one does not aim for a recession and I'm not sure how helpful that would be in making these adjustments. You are dealing in a situation where I suppose in one sense the classic response of the country inadvertently toward the kind of external imbalances that we have is a recession. We want to adopt some policies and follow through on some policies that avoid that.

Senator SARBANES. What is the reasonable range to which you're making reference in this?

Mr. VOLCKER. What I am reacting to is I see all the time great discussion of whether the growth rate is going to be 2.5, 3, 3.5, or 4 percent, and a great deal of argument and debate is on this subject we don't know very well anyway.

I would settle for the lower growth rate in 1987 and very important progress toward dealing with these imbalances—I guess I'm finding may self in a modified Proxmire quarter there—if those imbalances were being dealt with, because the implication would be that then we can sustain the growth for years ahead.

What good does it do—suppose hypothetically we could pump up the economy and grow at 4 percent in 1987 at the expense of imbalances that produce a recession in 1988? That doesn't make any sense.

Senator SARBANES. When you say you would settle for the lower growth rate, what growth rate are you referring to?

Mr. VOLCKER. Well, I suppose the way I worded the sentence means I don't want to be pinned to some particular decimal point growth rate.

Senator **Sarbanes**. Except that you cited a lot of numbers just before you said that, the lowest number of which I think was 2.5 percent. Is that the figure you're using?

Mr. **Volcker**. Well, that is toward the lower end of current projections, but I don't think there's anything magic about 2.5 percent. How much improvement are you going to give me on the structural imbalances as an offset?

Senator **Sarbanes**. Of course, if the growth rate goes down, the structural imbalances—some of them—are going to get worse, are they not?

Mr. **Volcker**. Well, no, not necessarily. But you ought to work on the structural imbalances and some of them might get better with a lower growth rate. But the object is to deal with the imbalances. I want to put the emphasis on dealing with the imbalances rather than a specific growth rate target. That is what I am trying to say. I think it's more important for the health of the economy over a period of time. Nobody is going to remember 5 years from now precisely what the growth rate was in 1987, presuming it's positive in some reasonable range. But you're going to be remembering 5 years from now whether we began making progress on those maladjustments or not.

Senator **Sarbanes**. Would you accept a growth rate that was so far into the low range that the unemployment rate went up by any substantial margin?

Mr. **Volcker**. You say, "Will I accept?" I'm not sure——

Senator **Sarbanes**. As part of this analysis, that we could entertain a growth rate that was so low that the unemployment rate went up by some substantial margin?

Mr. **Volcker**. Again, I have to say it's not a question particularly of what I will accept or not accept. These things have, to a degree, a life of their own. But even if you had a temporary increase in the unemployment rate, which I am not forecasting and not expecting, if that was accompanied by such clear progress in other directions that was going to be very temporary and really what was going on gives real new life to the economy in terms of its prospects in future years, I would not think that's a disaster.

Senator **Sarbanes**. What is the structural imbalance that that increase in the unemployment rate would contribute to? We've been through this before, where we get an increase in the unemployment rate to slow down the economy and wash out inflation. You've just given us a very favorable view on inflation. Now if the unemployment rate goes up, the budget deficit is going to go up automatically. That has to be addressed.

So you are complicating and compounding that structural imbalance rather than lessening it.

Mr. **Volcker**. You get in an argument about what structural means. Obviously, cyclically it would go up a little bit. But nobody is suggesting—at least I am not suggesting—we're going to aim for that. All I am saying is what I want to emphasize is the necessity for dealing with some of these other problems in a way that will maximize the chances of maintaining economic growth. And as part of that, maximize the chances of maintaining the progress on the price stability front. That's what you ought to be looking at as a matter of emphasis—how do we best improve the prospects for sustaining economic growth?

I don't agree with Senator Proxmire when—and maybe he didn't mean to say it—that a recession is inevitable in the next couple years. I agree, recessions come along and I don't think we've repealed the business cycle, but I think we have an opportunity here for putting measures in place that are going to sustain growth for a good many years down the road. These recessions arise eventually out of imbalances. Let's deal with the imbalances without a recession and we're going to be better off.

Senator **Sarbanes**. Congressman McMillan.

Representative **McMillan**. Chairman Volcker, turning back to the trade question again, I think we've agreed that perhaps our trade deficit hasn't entirely resulted from a lack of competitiveness, although that seems to be the buzz word these days that in fact it has in part resulted from practices, some perhaps perceived to be unfair, others just aggressive on the part of our trading partners. And it seems that you have conceded that perhaps some legislative measures might be helpful so long as they fall short of protectionism.

I gather by that that appropriate legislative action would increase the leverage of the United States in dealing successfully with these problems.

Mr. **Volcker**. Yes, but I am not going to get too deeply into this issue because I'm not enough of an expert in section this and that actions, and all the rest that are the meat and potatoes of limited trade legislation. And I cannot argue that there are not areas in which changes might be made.

I do know the dangers in this area are very great. You say that the trade deficit is partly due to these practices. Well, I don't know. I mean, those problems exist. But they existed 5 years ago, too, when we didn't have a deficit. They have been a structural fact that we have been dealing with for some years. I think the increase in the deficit has been almost entirely due to other factors, not just the great rise in the exchange rate that we had for a while, including the fact that we have been growing faster, at least particularly—we've been growing faster overall, but in terms of internally generated growth over the past 4 or 5 years, we have been growing substantially faster than other countries, and that has been an important contributor to this trade deficit.

That's what we have to see reversed and that's not just a question of our policy. It's half a question of our policy and half a question of other countries' policies. And that's where, in terms of the real money and improving the trade balance is, in my opinion, particularly now that we've substantially dealt with the exchange rate question.

Representative **McMillan**. Would the same answer, then, be applicable to shifting from the trade deficit to the balance of payments deficit? I was going to ask the question in that connection, is additional leverage in terms of let's say legislative action at all desirable in terms of dealing with that problem?

Mr. **Volcker**. Well, I'm not going to comment in detail, but it may be. For instance, there's the whole area of copyrights and that kind of thing which very much concern people with their fairness. I'm no expert in this area, but maybe some legislation is needed.

But my point is, you could legislate that and create responses abroad—let's say we did and that element of unfairness was eliminated. It would make very little difference in our trade balance over the next few years. It's just not the kind of action that has the gross impact on these figures that's going to be noticeable in the short run. Now it may have great implications down the road, but it's not going to shift our trade balance in the time period that I'm talking about. And that would be true in some other areas. In some areas, it would have an impact, but as a matter of scale, when we're dealing with a $150 billion deficit, you could deal with a lot of unfair trade practices—and I've heard Mr. Yeutter and others make this comment—I forget how many billions they use, but it's more in the neighborhood of $15 billion if we had amazing success than $150 billion. So you've got to have some sense of relative importance here.

Representative **McMillan**. One further question on that in terms of currency devaluation of the dollar. There was an article or analysis that I think was published last Friday that tried to weigh that by product categories, oversimplified, the bottom line being that the decline of the dollar has had very little impact on critical areas of problems in this country.

Would you basically agree with that kind of approach?

Mr. **Volcker**. I agree with one comment you made that all these things are very simplified and there's no single index that's going to capture reality. But I do think that the exchange rate change relative to our main industrial competitors has been so large it's bound to have an impact.

What is often not understood or emphasized is that when our exchange rate changes as much as it has relative to Germany, Japan, and other European countries, that should impact trade with Korea, Taiwan, Singapore, and Hong Kong and Latin America and everything else because it is much more profitable for Korea, say, now to export to Japan and to import from the United States than it was 2 years ago. And that should affect our trading patterns with these countries if their exchange rate hadn't changed at all relative to the dollar.

We live in a multilateral world. Now saying that often cites part of the problem. If, as a practical matter, Korea cannot export to Japan because of trade restrictions in Japan—forget about Japan's trade restrictions with us—if they won't let in Korean goods, you don't get that adjustment which indirectly helps us. If they can't get it into Japan, whatever the exchange rate, they are going to continue to export to us.

So this question of trade barriers has to be looked at—maybe it's more important to look at it from that direction, or as important, as the restrictions directly against us.

Representative **McMillan**. I would agree with that. Thank you very much.

Senator **Sarbanes**. Senator Melcher.

Senator **Melcher**. Well, Mr. Volcker, I am not as enamored with the state of the economy as you perhaps are. It's true inflation is certainly down and energy is much cheaper, a big factor in measuring inflation and cost of living. Agricultural commodities are all down. That's another significant factor.

So the sum and substance of your testimony in regard to getting Federal deficits down is well made.

We have the option here in Congress of looking at a broad array of areas where cuts can be made and I suspect that a lot of us will look at the areas where spending has increased over the past several years—the contracts the Pentagon has let, foreign aid. Belt-tightening on domestic programs you commented on the agricultural program costs, that could be reduced. In fact, if exports of agricultural commodities pick up, it is assumed that commodity prices will stabilize, perhaps strengthen somewhat and, therefore, there would be less spending out of the Treasury on the program costs.

But when we come down to the fact that if there are going to be some adjustments made in the economy in the areas of basic industries, such as agriculture and mining and forest products also, they have debt. If they're going to make much of a recovery they are going to have to get that debt serviced at lower rates of interest.

I am a little bit disturbed by your answers on the Farm Credit System because you don't have any real recommendations except that it not be the Federal Reserve Board that's responsible.

Mr. **Volcker**. Well, that's the question you asked me I think.

Senator **Melcher**. Yes. Well, either way, whether it's Congress, if it's deemed necessary to save the Farm Credit System, one or the other has to move. We can't debate it. We've got to do one or the other.

Mr. **Volcker**. Well, the Farm Credit System, as you know very well, is a very complicated problem. There are many problems within the Farm Credit System and great tugs-of-war going on between different sectors of the Farm Credit System. Congress did pass some legislation a year or so ago that created the possibility certainly of Government assistance under certain conditions.

In effect, you said they've got to clean up their own act first. And I don't know how much progress they have made in that direction. I think they have made some, but my impression is a good deal more has to be done in that area of self-help or help between different arms of the Farm Credit System before they can come to the Congress with clean hands, so to speak, in terms of your own legislation.

Senator **Melcher**. I think that time has passed, this sort of round-robin criticism of all aspects of one part of the Farm Credit System or of one level criticizing the other. I'm speaking more of an adjustment in the nature of halting their decline.

And it isn't very complicated what they need. They've got some bonds out that are about 14 percent interest and they need to be offset with some capital at 5 percent interest so they can survive.

Mr. **Volcker**. If I may just interject once more, you say it's not very complicated what they need. As in any case where you contemplate providing assistance of this sort, it seems to me it is perfectly reasonable to ask that they first help themselves to the extent they can and get their own act cleaned up, or you're just feeding money into an endless proposition.

Senator **Melcher**. Well, there can be carping between one level or the other of the Farm Credit System as to who should do something different. I'm only speaking about survival right now and whether or not it's in the public interest that the Farm Credit System does survive. I say that it's simple what they need. They need some offsetting cheap money to balance out their very high interest rate bonds.

Now, other than setting the precedent, which you would hate to set for the Federal Reserve Board, why is it not essential or if it's deemed essential by Congress, why is it not better to take the money from the Federal Reserve's functions rather than from the Treasury?

Mr. VOLCKER. Well, the economic effects under some circumstances could be similar, but the great danger is that you are using the money creation machinery to deal with a sectoral problem. That doesn't say the sectoral problem doesn't have to be dealt with, but do you want to use the money creating machinery for that purpose?

And I would say, no, you don't.

Senator MELCHER. You don't think it's isolated enough to—it's less isolated—is the answer that the money creating situation is less isolated at the Federal Reserve than it is at the Treasury?

Mr. VOLCKER. Yes. I mean that everybody wants to use the money creation process, get out from under the appropriations process, create some new money to solve sectoral problems. If you do it for agriculture, you're going to end up doing it for commercial construction. You're going to end up doing it for LDC's. You're going to end up doing it for everybody.

Senator MELCHER. Well, the $4.5 billion it took for Continental Illinois a few years ago—is there something different now when we talk about the Farm Credit System? I think, correctly, we moved in for Continental Illinois for about $4.5 billion within a few days.

Mr. VOLCKER. I think you're thinking of the FDIC now.

Senator MELCHER. Yes, I am thinking of the FDIC. Wasn't that good?

Mr. VOLCKER. Oh, yes.

Senator MELCHER. What's the difference now?

Mr. VOLCKER. I think that was appropriate policy. The difference is that—we lent Continental Illinois for a while substantially more money than that. That is protection of the banking system. To provide liquidity to the banking system, is a basic part of our function, that the banks are treated differently in that respect and they always have been, and that is the one sector of the economy that has these protections.

And what justifies that in a general sense is that the health of the banking system and the stability of the banking system has so many indirect influences on other sectors of the economy and so many innocent third parties in the economy as a whole gets hurt by a breakdown in the banking system.

Now that is true of any sector to some extent, but I think there is a difference in kind between the banking system—and that is well-defined and it partly gets back to our arguments over the structure of the banking system—we don't want to protect the whole economy in that way, but the banking system I do think is a special animal that needs that kind of protection.

So far as the FDIC money is concerned, I point out it was contributed by assessments on the banks themselves. In that sense, it was a self-help insurance arrangement.

Senator MELCHER. Well, I think the banking industry needs to be protected in the final analysis. I also think the Farm Credit System is exactly in the same position and it needs to be protected in the final analysis from its total demise.

Mr. VOLCKER. And I think Congress provided some indications of that in their legislation last year, but it also had some quid pro quos.

Senator SARBANES. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman. I have two or three questions that I'd like to ask. One, first, is on interest rates. The discount rate is presently 5.5 percent and the Federal funds rate is about 6 percent. And those two interest rates are viewed as benchmarks by a lot of financial watchers as affecting the rest of the market.

Can you briefly describe how you use these two interest rates to regulate monetary policy?

The second question is, With respect to the large jump in the money supply in December, did that occur because of planning or was it some other aberration that caused that? Then I noticed that you put the Federal funds rate up to meet that and it seemed to bring the money supply back down.

Mr. VOLCKER. Well, we control the discount rate directly, of course. We set the discount rate. It's an administrative decision. We do not control the Federal funds rate that directly. That's set in the market. But the two rates tend to be related.

The Federal funds rate is usually above the discount rate because we don't invite the banks to borrow all the time. We tell them they can borrow when they have a particular need. So they will buy and sell funds with each other, which is what the Federal funds rate is, typically at rates somewhat above the discount rate. And that relationship is affected by how freely we provide reserves.

Now that burst in the money supply in M1 in December was not planned. I think it reflected in considerable part the enormous volume of activity in financial markets and that activity, to some considerable degree measured by the increase in the M1 money supply, was fairly passively accommodated by us temporarily.

Senator SYMMS. So there was a way you pushed up the Federal funds rate?

Mr. VOLCKER. Well, the market pushed up the Federal funds rate.

Senator SYMMS. You changed the discount rate?

Mr. VOLCKER. We didn't change the discount rate. The market, because of those exceptional demands for funds, pushed up the Federal funds rate, despite the increase in the money supply. If there had been no increase in the money supply, those rates would have been skyrocketed. If you didn't have a Federal Reserve System, God knows where those Federal funds rates would have gone. But for a while they did go higher, reflecting those exceptional demands, and then as you got through that year-end period and that exceptional period of activity it tended to come down again. And the exceptional Federal funds rate evaporated and didn't have much effect on the rest of the market because the market anticipated that it would be temporary. That bulge in the money supply has been somewhat more than half offset by subsequent declines in M1, but it's not fully offset.

The basic growth rate in M1, as Senator Proxmire emphasized, has been pretty high.

Senator SYMMS. OK. Well, thank you very much.

On another subject, you say "A self-generating cumulative process of currency depreciation and inflation serves no one's interest. Economic history is littered with examples of countries that acted as if currency depreciation alone could substitute for other action to restore balance and competitiveness to their economies."

Since the Plaza accord, the dollar has declined from about 240 yen down to 152, and from 2.84 German marks down to 1.81 marks, and the exchange rate on the British pound has moved from $1.37 to $1.52. Yet, at the same time, the Canadian dollar and the Mexican peso have actually weakened and the Korean, Taiwanese, Hong Kong, Singapore, and Third World currencies haven't changed and we aren't seeing any benefits there with exchange rates.

What should we expect to see in the next few years?

Mr. VOLCKER. Well, I think you should see benefits in those countries from the exchange rate changes that have taken place between the dollar in Europe and the dollar in Japan for the reasons I suggested earlier. The Koreans now have a much greater incentive to export to Japan. They have better incentives to import from us. So we should see an improved trade balance with Korea if all markets are open, even if their exchange rate doesn't change.

In fact, in the case of Korea and Taiwan, I think there is room for them to open up their markets and help us more directly. But the mere fact that their exchange rate hasn't changed doesn't mean they are not affected by these other exchange rates.

And the fact that the Mexican peso has declined against the dollar is accompanied by another fact and that is that the inflation rate in Mexico is about 100 percent. Naturally, you would expect the peso to decline against the dollar. We can't improve our trade position substantially against Mexico when they are so hard pressed to export on the one side and to reduce imports on the other side. They are barely keeping their nose above water.

Now what we would like to see in the case of Mexico, as in the case of Korea, is markets open to them elsewhere, that they do more exporting to Europe, more exporting to Japan, less relative exporting to us, and that our products are more attractive in Mexico.

Now those things are all determined by exchange rates between us and Europe, not between us and Mexico or between us and Japan.

What's important is that those other markets are open to them and it is quite true, if one looks at the last 5 years or so, there's been a substantial increase in exports, particularly nonoil exports, by Mexico. Most of those are coming to us because our markets are open to them and for a while the dollar looked—it was a good place to sell relative to Europe and Japan. Now that has changed and you would like to see a redirection of those trade flows.

Senator **Symms**. Thank you very much, Mr. Chairman. I want to ask one last question if I could. There are people in this town who have suggested that we cancel the 1988 reduction of the top-bracket tax rates that we legislated in 1986 and there are a lot of reasons why I wouldn't want to do this, one of which is I think it would have a dramatic, negative impact on business planning if the Tax Code is going to continue to be opened up and kept in a turmoil at all times.

Now you're talking here about deficits, that you don't want to see these big deficits. And all of us I think share that concern.

If the Congress fails to meet the targets of Gramm-Rudman by cutting spending and if the President caves in and decides he will go along with some kind of a tax increase, I'd like to ask a two-pronged question.

One is, how much more valuable to future economic stability is cutting Government spending as a way of deficit reduction as opposed to increasing revenue as a way of deficit reduction; and second, how much risk, if we do any revenue increasing, is there to completely disrupt the business planners in the private sector because of the instability in the Congress to stand firm on any kind of a tax policy and keep it in a constant turmoil?

Mr. **Volcker**. Well, you obviously reflect all the competing priorities that you have to deal with. I think the answer to your questions is in one sense pretty clear. Conceptually it's clear, but practically, I don't know. From a purely economic standpoint, it's better to reduce the expenditures and I think you will then be giving more head room to the private economy to make the adjustments that we're talking about.

Now you have other objectives than purely those of economic efficiency which control the spending total. You've got defense considerations. You've got all the social program considerations.

But from a purely economic standpoint in promoting the adjustments I'm talking about, the more you can do on spending, the better.

Now if you eventually have to do something on revenues because of those other priorities on spending, then, all things being equal, you would like to keep the Tax Code steady, but there are things you can do on taxes that don't affect what you did last year.

Congressman Fish raised the question of some kind of tax on the energy area. That's one possibility. You could have a more general type of tax on consumption. So there are various possibilities, some of which are better than others from an economic efficiency standpoint.

Senator **Symms**. Thank you very much, Chairman Volcker. My time has expired and I again thank you for being with us this morning. It's been a very excellent hearing.

Senator **Sarbanes**. Congressman Scheuer.

Representative **Scheuer**. Thank you, Mr. Chairman. Mr. Volcker, the 1987 Report of the Council of Economic Advisers to the President was very vague on what the administration thought the monetary policy ought to be in 1987 and how it ought to be conducted.

Has the Fed received any guidance from the administration?

Mr. **Volcker**. Well, I don't think in particular, no. It obviously comes up in conversations occasionally, but we haven't received any blueprint, no.

Representative **Scheuer**. No general policy guidance?

Mr. **Volcker**. No.

Representative **Scheuer**. They didn't give us very much.

Mr. **Volcker**. No policy guidance other than what you read in the newspapers once in a while. I don't like to call that guidance. We have comments once in a while, but it's our responsibility.

Represenatative **Scheuer**. Let me ask you a question that's a little bit out of the orbit of your job description but we've talked a lot this morning about access to foreign markets and opening up markets and we've had an extremely frustrating experience, especially with the Japanese, on negotiating each particular product or commodity or import whether it be consumer electronics or telephonic equipment or what have you. And it seems that they have such a congeries that, taken together, constitute an impenetrable thicket. Some of these are legal. Some of these are administrative or bureaucratic. Some of them are cultural. Some of them are traditional. And it takes us years to negotiate each one and by the time we finish we find that by some process of prestidigitation the thicket has grown a dozen feet high through another process and it's just as impenetrable as it was before.

We don't seem to be able to solve the problem. We're on a treadmill in negotiating item by item, product by product, commodity by commodity.

What would your view be of taking the theory of the father—let's say I beat the hell out of my kids once a day because I figure if I don't know what they've done wrong, they know what they've done wrong.

And transferring that logic to the Japanese, for example, we say to them, "We don't understand this impenetrable thicket that you've erected, but you do. And we're not going to continue this negotiating item by item, product by product. We're simply going to tell you that your trade deficit with us, which is now $65 or $70 billion a year, is unacceptable and we want you to work it down by $5 or $10 billion a year. And by the time it gets down to $8, $10, $12, or $15 billion, we can live with that. But you have all kinds of options. You can buy more from us. You can open up your markets in ways and means and strategems that we can't even comprehend. You can cope with that problem, the total problem, and we're just going to request of you that you reduce that trade deficit with us to $10 billion a year either through buying more or through selling less—hopefully, buy more of our products, but manage it any way you want, but that's the result we want to achieve on the bottom line. And if you don't, then we're going to have to listen to the legislative branch on Capitol Hill and get into all kinds of protectionist things that we really don't want to get into."

How about that as a solution?

Mr. **Volcker**. Well, I think part of the problem is maybe implicit in the analogy you used about your kids. You might end up with some pretty neurotic kids if you carry that approach too far.

But I think there is something to what you say in the sense that if the imbalances persist too long or become too great, and indeed there is a recalcitrance to work this through, you almost end up with the kind of approach that you're talking about—not unilaterally, but multilaterally. I mean, I don't think it's quite right to look at only their balance vis-a-vis us. But if it's true worldwide, and the imbalance is so great, market forces themselves eventually will force disorderly resolution.

And you're saying they ought to be more aggressive in bringing it about constructively. I think in some very broad sense that's correct, but I do think that we are on an approach that can be more constructive than the kind of command decision that you're talking about which would have to be multilateral, it seems to me, to make any sense at all.

But you are making vivid what I think is the reality, that they have to cooperate in this process so that their overall balance surplus does decline in an orderly and constructive way. You can't quite do that by fiat, but that ultimate implication ought to be there.

Representative SCHEUER. Thank you, Mr. Chairman.

Senator SARBANES. Congressman Fish.

Representative FISH. Thank you, Mr. Chairman. Mr. Vocker, you left us with a message that one of the principal ways of reducing the trade deficit is by increased manufacturing.

Now the administration has proposed a package, about a 11-page President's competitiveness package, that involves a lot of the efforts that we're familiar with that Secretary Baker is making, the intellectual property legislative reforms that you mentioned, others in the antitrust area that will be coming. Both of those will be coming to my committee in the House. The worker retraining provision.

My question is, Is increased manufacturing synonymous with competitiveness as viewed by the administration or would you like to see more in the area of competitiveness that is more directly geared to increasing manufacturing, more than they've offered us so far?

Mr. VOLCKER. Well, let me put it this way. When I say increased manufacturing has to be the solution or a main part of the solution, you don't get the solution by just increasing manufacturing. You've got to have the markets for it.

And I would hope that at present exchange rates and with growth abroad—and those things are important—you will have the natural incentives to bring about the increase in manufacturing. But you start by creating the right environment so that the investment takes place and the exports take place and the competition with imports takes place.

Now my concern is how we achieve that in an environment that maintains our progress toward price stability. We're going to have to shift more resources into manufacturing and how do we do that while maintaining the overall, I think, quite good price performance of recent years. When they have to invest more, they will see higher prices of imports, there will be temptations to raise prices, and we see some of that. That, then, gets back to some of the questions you're raising.

How do you ease the process of investment? Congress took away some incentives last year instead of improving them, but we do have more favorable financial markets.

Do we have adequate training programs for labor? What about education? All those things that you mentioned are relevant in terms of shifting resources into manufacturing as the opportunity exists, as it must if we're going to improve the trade balance.

Representative FISH. Finally—and I hope this question wasn't asked when I was out of the room—you have spoken about the Federal budget deficit as being the culprit in many, many respects here behind the trade deficit, behind the low savings rates, et cetera.

What if the Congress simply fails during the next few years to meet the Gramm-Rudman-Hollings levels; we just simply can't bring ourselves to ratchet down each year to those levels, and deficits stay over the next several years at $100 to $150 billion annually? Would you like to give us your forecast as to what the result of that situation would be?

Mr. VOLCKER. Well, I say this with some timidity because putting targets out there is often a good idea, but our success does not rest upon meeting the precise Gramm-Rudman targets.

I think what we need to do is to make discernible progress, taking account of any cyclical factors, year after year for a while. You talk about getting down to $100 billion. That's already a considerable improvement. That's not good enough, I think, over the years ahead, but it's a substantial improvement from $220. And if we got to $100 billion in 2 or 3 years and the economy is growing, it looks a lot better than it's looked in the last few years. So that would be progress, so long as we don't stop there.

If we made no progress at all, then I think you're just whistling when you say you want to get rid of the trade deficit because we are going to need a capital inflow and if we don't have the capital, and you have lack of progress on the budget deficit, and we somehow at the same time had great progress on the trade deficit, we're not going to have enough money in the United States to finance capital investment, to finance housing, and presumably you would have great pressure on interest rates, you would be greatly increasing the risks of a recession because of financial dislocations. They just don't go together.

You can't get rid of the trade deficit without getting rid of the capital inflow. If you get rid of the capital inflow without getting rid of the budget deficit or sharply reducing the budget deficit, you've got a mess.

And that is the basic point that I want to emphasize. There is just two sides, in that sense, of the same coin in terms of the financial balance of the American economy. And I don't really think you have the option of continuing the budget deficit at the expense of continuing the trade deficit because at some point the country is going to get heavily enough indebted and there's going to be enough lack of confidence in the currency so that you have a mess in another direction.

The exchange rate will go down and you'll bring on inflationary pressures and financial pressures through a different group.

So I don't think you have any real option of just proceeding in the present mode. That's why, to come back to the conversation I had with Senator Sarbanes earlier—that's why I emphasized the importance of dealing with these imbalances because you haven't bought much if you bought a good high rate of economic growth in 1987 but made the imbalances worse, because you simply undercut the prospects of continuing and sustaining growth in the future.

Representative **Fish**. Thank you very much, Mr. Chairman.

Senator **Sarbanes**. Senator Proxmire.

Senator **Proxmire**. Chairman Volcker, yesterday, one of the wisest men on Wall Street and one of the wisest men in the country on our economy, Henry Kaufman, said that we simply cannot afford to have a recession. That seems to me to be a dangerous attitude, even though I have great respect for Mr. Kaufman, as I said, because what that implies is that we have to do everything—everything—just cut out all stops in order to prevent a recession, although as you and I know, recessions come regularly.

The reason Mr. Kaufman said this, as I understand it, is because he feels we have a mountain of debt and a recession this time would be far more serious than anything we've had since the depression because there would be widespread insolvencies and a tremendous number of corporate bankruptcies and to recover from that kind of situation would be very difficult. It would be a terrific blow to this country.

Do you agree with Mr. Kaufman that we can't afford to have a recession?

Mr. **Volcker**. I don't agree with the implication that we can prevent recessions by fiat just because we don't like them. You've got to be doing the things that are necessary to minimize the possibility over time.

I also do not agree that we can avoid a recession or avoid the problem by inflation. I think that will ultimately bring a bigger recession.

What a recession, should one occur at some point, would do to us depends upon a lot of things. Are we moving in the right directions in dealing with these imbalances or not? In terms of our present condition, a great deal would rest upon what the rest of the world is doing. If a recession in the United States produces a worldwide recession, we've got a big problem. If the rest of the world is growing strongly, I don't think we would have a recession that lasted very long in the United States if we had one.

Senator **Proxmire**. Now what can we do to stop a recession now that we've gone all out already on our fiscal policy, gone all out, in my view at least, on our monetary policy? Haven't we used up all of our ammunition? Aren't we like the fellow who was cornered in an alley and he's fired every one of the six shots that he's got in his clip?

Under these circumstances, what do we do? Do we cut taxes even further? Do we sharply increase spending?

Mr. **Volcker**. I think what we do is move in the direction that I've been urging here.

Senator **Proxmire**. All right. Well, take the direction you've been urging over and over again. What you've been saying is what we have to do is persuade our trading partners in the world to permit their economies to grow and this is on the assumption that they haven't grown as fast as we have.

Now the figures I have show that the growth with our trading partners, OECD in 1986 was 2.5 percent, the same as the United States. Over the past 5 years, OECD growth has been about the same as we have in this country. So it seems to me that to say that we can rely on further growth by our trading partners is a copout.

Mr. **Volcker**. Well, I think I have somewhat different figures as to what the tendency has been over these past 3 or 4 years, which I will try to extract in a moment if I can. But by and large, those countries have a fair amount of excess capacity now and some of the key countries have very good price performance and the growth that they have had over this period as a whole—not in 1986 but earlier—was promoted by external growth, not as a matter of emphasis on internal growth. So apart from their rate of growth, which has been subdued, I think that is a fair adjective—but apart from the subdued nature of the overall growth, it has during that period as a whole been too dependent upon external growth and not internal growth.

We began to see that shift in a constructive direction in 1986 and that has to continue and, of course, you would like to see it a little higher but we're not going to get any miracles in that respect.

The figures that I have here just for the Group of Ten (outside the United States) are 1.8, 3.1, 2.8, and 2.25 percent, probably, last year. Except in 1985, where it was just a hair higher than ours, those were all lower growth rates than ours.

Senator **Proxmire**. That's just what I said. Those add up. You said 3.1 in one case, 2.8 in another, it adds up to 2.5——

Mr. **Volcker**. They've been growing about 2.5, but we've been growing more than 2.5.

Senator **Proxmire**. Not last year.

Mr. **Volcker**. We grew 2.5 in 1986, but I'm looking at this 4-year period. In 1986, our estimate is they only grew 2.25. They have averaged about 2.5 over the period since 1982.

Senator **Proxmire**. Isn't it true that the United States has grown 2.4 percent since 1980?

Mr. **Volcker**. Since 1980, I haven't got the figure here, but we've grown—I haven't got the average for the period, but we've grown about 4 percent it looks like, on the average, since 1982. We've grown more than they have—this is the Group of Ten—every year except 1985, when we were about the same.

Let me give you just something that illustrates the problem. For domestic demand, which is where the problem has been, their growth rate in 1983 was 1.4; ours was 5.1. In 1984, 2.5; ours was 8.3. In 1985, 2.6 them; 3.4 us. Even in 1986 when their domestic growth picked up, 3.4; we were 3.6. So every year in terms of domestic growth, ours has been greater.

Now that's a reflection that their trade surpluses were increasing and our trade deficit was increasing right through this period. That has to be reversed.

Senator **Proxmire**. Isn't that also a reflection of the far different attitude in a country like Germany and, of course, in Japan too, of their attitude toward inflation? Germany went through that crushing inflation after World War I which I think has had an enormous effect on their attitude.

Mr. VOLCKER. Yes, there's no doubt.

Senator PROXMIRE. And I think a constructive effect, in my view, because they are willing to do whatever it takes to prevent inflation.

Mr. VOLCKER. I agree with that.

Senator PROXMIRE. Now let's face it. We're not going to be able to turn that around.

Mr. VOLCKER. I would characterize their attitude toward inflation as the same as mine. It's bad.

Senator PROXMIRE. Your policies, Mr. Chairman, are leading us in that direction when you have the kind of explosive growth in money supply.

Mr. VOLCKER. Well, that's a difference in judgment.

Senator PROXMIRE. Let me ask just one more question relating to this.

We have had extraordinarily good figures in the last year or so with respect to inflation and interest rates. Interest rates are about 40 percent of what they were in 1981. Inflation is down from 12.4 percent in 1980 to 1.1 percent last year and it just seems to me that this is based on a glut of labor and then a glut of commodities—food, oil, and other commodities.

But hasn't it been true in country after country, that if they increase their money supply sufficiently, that they will still have too much money chasing too few goods even though they have high unemployment, even though they may have an excess of capacity and so forth?

Mr. VOLCKER. Well, the test of whether you've got too much money chasing too few goods lies in the eating I guess. Are prices going up?

Now I agree you cannot judge that instantaneously. We will know whether we had too much money a couple years from now rather than today. Now obviously our policy, so far as I am concerned, is based upon a judgment that that is not the case. But I can't prove it to you. I can't prove it to you until 1989 and some things will depend on what happens between now and 1989.

Without any question, we have accommodated an increase in the money supply that facilitates a lot of financial activity and it's been facilitating more financial activity than real activity. And that's another matter of judgment as to when that goes too far.

Senator PROXMIRE. My time is up, but doesn't that 6 feet 6 inches frame of yours shiver and shake when you look at the 17-percent increase in the money supply last year? Doesn't that really make you wonder about——

Mr. VOLCKER. I would rather not see it. It takes a lot of explanation and I can explain some of it but I can't explain all of it. I know there's a lot of activity in financial markets. I am reassured when I look at some other indicators and I arrive at the overall judgment that, under all the circumstances of 1986, it was not unreasonable to have accommodated that increase in M1.

That does not mean that I'm in love with that particular figure or that in other circumstances anything like that would be appropriate. And I think we have to be quite alert to changing that process in other circumstances should they arise.

Senator **Proxmire**. Thank you, Mr. Chairman.

Senator **Sarbanes**. Chairman Volcker, I want to, on the basis of our last discussion, register very sharp disagreement with you about the notion that we could entertain progress in 1987 for the economy if it meant an overall economic growth rate that resulted in rising unemployment. I think unemployment is too high as it is and that one of the important objectives of our economic policy ought to be to get unemployment down. I think it's moved down too slowly. But in any event, I certainly would not entertain the proposition that we could be indifferent to a growth rate that allowed rising unemployment.

Mr. **Volcker**. I did not want to suggest any indifference and I'm not sure how sharp our disagreement is. We may have some, but I would also——

Senator **Sarbanes**. If I understood correctly, you were prepared to entertain a growth rate that would result in rising unemployment. I think that would be a failure in economic policy.

Mr. **Volcker**. Well, let me say I think the unemployment rate is too high, too, and we ought to get it down over time. If one was faced with a choice—and things are never this simple—but a few tenths increase in the unemployment rate and the prospect of reduction for years thereafter, and a choice between not having an increase in the unemployment rate and a recession of some severity or an inflation, which would be the same thing, in my judgment, of some severity——

Senator **Sarbanes**. You used to make that argument when you were concerned about the inflation rate. Not all of us necessarily agreed with it even then, but at least I think it had some validity to it. Now we've got the best inflation record over the past year than we've had in years, and you're still talking about letting the unemployment rate go up, accepting a proposition with respect to policy and economic growth where unemployment would rise.

You're about the only person who's come before us been prepared to take that position. The administration doesn't take that position.

Mr. **Volcker**. I have not suggested that we are aiming for an increase in unemployment. Quite the contrary. I am suggesting——

Senator **Sarbanes**. What your statement said is that it's not so much whether we reach some specific rate of overall economic growth in assessing progress in 1987, at least within some reasonable range.

Mr. **Volcker**. That's what I said.

Senator **Sarbanes**. I tried to probe what that reasonable range is. Apparently you encompass within the reasonable range a rate of overall economic growth that would bring with it rising unemployment. My contention is that is not reasonable, that that ought not to be included within the reasonable range.

We may argue about how much unemployment ought to go down and how fast, but to entertain the notion that it ought to go up, particularly when we've got the performance that we've had on the inflation front, seems to me runs contrary to what our objectives ought to be.

Mr. VOLCKER. I agree.

Senator SARBANES. Furthermore, it's going to compound some of the very problems you've talked about, including the Federal deficit.

Mr. VOLCKER. I never said it ought to go up. I said sometimes we're faced with choices and what I'm interested in is getting that unemployment rate as low as you can over as long a period of time as possible consistent with stability. And I'm always going to worry about inflation.

Senator SARBANES. Congressman Scheuer put to you a question about policy guidance from the White House with respect to monetary policy.

When was the last time you met with the President to discuss economic policy?

Mr. VOLCKER. I don't remember, but it would be quite a while ago.

Senator SARBANES. A half a year, three-quarters of a year, a year?

Mr. VOLCKER. In that range. [Laughter.]

Senator SARBANES. You also said in responding to some questions about the deficit that from a purely economic standpoint you wanted budget cuts. But then you said there were social policy considerations and there were national security and defense considerations.

Later, in addressing the question of lowering the trade imbalance, you made reference to the need for programs in education and in worker training. Of course, I would add to that research and development and physical infrastructure.

The question is, from a purely economic standpoint, is not a wise expenditure on education and training and infrastructure and research and development an investment in the future strength of the economy? In other words, how far can we cut back in areas directly related to an improved economic performance, to better productivity, and therefore, a heightened ability to compete?

Mr. VOLCKER. Well, I think the whole question in that area—and I have no particular expertise about it—is your word "wise." And there are all kinds of arguments about how effective particular education, training, and research and development programs are, as you well know. I think it all depends upon how they are constructed and what they are and I don't think I could add much to the debate on that subject.

Senator SARBANES. But from the economic point of view, a certain expenditure in that area is necessary, isn't it, to strengthen our competitive ability?

Mr. VOLCKER. If a certain expenditure in that area is highly productive, it's worth making. But that's a tautology.

Senator SARBANES. You say that fresh impetus is needed to deal with the acute debt problem in Latin America. What do you mean by fresh impetus?

Mr. VOLCKER. Well, what I mean is that right now there is at least a threat of something of an impasse developing where a lot of countries are at a stage where, often with the support of the IMF and participation of the World Bank, they need some refinancing or some new financing and quite a lot is lined up in that area and has been delayed and there needs to be some kind of a breakthrough here to get that financing part of the job completed.

Senator **Sarbanes**. You've talked about Japan and Germany, which are running these very large current account balances, expanding their economies and their domestic demand as one way of trying to deal with the trade balance. I've seen reports that at the best that would be $10 billion perhaps on the U.S. trade figure.

What about their responsibility to move some of their surplus into the multilateral institutions for the purpose of helping to start up the engine of growth in the developing world? In other words, it's a burden the United States carried for a long time when it was running current account surpluses. That would be a way of expanding world markets and altering these trade imbalances through the natural working of competitive forces, if they moved some of the large surpluses they have accumulated into this effort.

Mr. **Volcker**. Well, I think the more that they could move funds into these countries, the best way to do it would be to do it directly if they could.

Senator **Sarbanes**. You mean bilaterally?

Mr. **Volcker**. Yes.

Senator **Sarbanes**. Well, then they tie them up with trade arrangements which only compound the problem.

Mr. **Volcker**. The best way to do it would be to invest the money there or lend the money there or give the money there without tying it up. The next best way I think would be through the international institutions. The more of that, the better.

What you find here, of course, is that those surpluses are accumulating in the private sectors of those economies and to direct funds to those other institutions—well, they could borrow in those markets and to the extent they direct their borrowings toward those markets, but those are all at market rates—it's helpful, but if you're going to just inject money into those institutions officially it's therefore official funds, it hits their budgets, and the prospects for really massive shifting of that kind to their budgets I don't think is very high.

Senator **Sarbanes**. My time is up. Congressman Scheuer.

Represenatative **Scheuer**. I have no more questions.

Senator **Sarbanes**. Mr. Chairman, thank you very much. We appreciate you appearing before the committee.

[Whereupon, at 12:25 p.m., the committee recessed, to reconvene at 9:30 a.m., Thursday, February 12, 1987.]

THE 1987 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 12, 1987

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to recess, at 9:35 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senator Sarbanes.

Also present: William R. Buechner, professional staff member.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator **Sarbanes**. Today the Joint Economic Committee resumes its hearing in conjunction with the 1987 Economic Report of the President. The committee this morning will hear testimony from witnesses in the private sector on current economic policies and on the issues raised in this year's Economic Report.

On the 29th of January, Beryl Sprinkel, Chairman of the Council of Economic Advisers, presented the 1987 Economic Report of the President to the Joint Economic Committee. Prior to that date, the committee had heard testimony from private witnesses on prospects for the U.S. economy and on the status of the United States in the world economy. Since Chairman Sprinkel's testimony, the committee has also received testimony from Treasury Secretary James Baker and from the Chairman of the Board of Governors of the Federal Reserve, Paul Volcker.

Today, as I indicated, we return to the private sector for further analysis of the administration's economic policies. Our witnesses have been asked to evaluate those policies and also to indicate where they think those policies will take the American economy in 1987 and the years beyond.

We will start this morning with a panel of four prominent business and financial economists: Edgar Fiedler, vice president and economic counselor of the Conference Board in New York; Robert Hormats, vice president of Goldman Sachs & Co.; Jerry Jasinowski, senior vice president and chief economist of the National Association of Manufacturers, here in Washington; and Allen Sinai, chief economist and managing director of Shearson Lehman Bros.

This panel will be followed by Rabbi David Saperstein, member of the board of directors of the National Committee for Full Employment, who will focus on the problems of unemployment, underemployment, and declining earnings.

And then we will hear from an elder statesman of the economics profession and a good friend of the committee, the Honorable Leon Keyserling, who is president of the Conference on Economic Progress. From 1946 through 1953, Mr. Keyserling served President Truman as Vice Chairman and then Chairman of the Council of Economic Advisers.

We will start with our panel. Gentlemen, we are pleased to have you with us this morning. I don't know whether you may have worked out amongst yourselves what we would regard as a sensible order in which to proceed. If not, we can start from the right and go to the left or we can—had you worked out an arrangement?

Mr. **HORMATS**. Maybe alphabetical order.

Senator **SARBANES**. Well, we can do it alphabetically. That avoids the question of whether we're moving from right to left or left to right.

Mr. **HORMATS**. It's less ideological.

Senator **SARBANES**. You put my knowledge of the alphabet into question. Mr. Fiedler, why don't you start off.

STATEMENT OF EDGAR R. FIEDLER, VICE PRESIDENT AND ECONOMIC COUNSELOR, THE CONFERENCE BOARD

Mr. **FIEDLER**. All right. Thank you, Mr. Chairman. I'll be as glad to take the honor that way as any way.

I have given you all copies of my prepared statement. I want to go through it quickly starting with a few words about the 1987 outlook and then turn to the important issue of the long-term growth of the economy.

Almost all of the forecasts that have been discussed before this committee for 1987, including the administration's, fall within a narrow range of what represents a reasonable expectation for the year ahead and it seems to me that the differences among those forecasts are really not worth debating, with perhaps a few exceptions.

It seems to me the petulant quibbling in which we so often engage over minor differences in forecasts fully justifies the public's stigma so often encountered by economists and politicians as well.

The latest signs and portents show an improving outlook both here and around the world. I have attached to my prepared statement a copy of the latest issue of the Conference Board's International Economic Scoreboard which represents the leading indexes for nine of the major industrial countries and those leading indexes are now pointing toward something of a strengthening in the business cycle in every country except the United Kingdom.

I got some partially updated information yesterday on those numbers and they confirm that conclusion, that the cycle is strengthening. No boom signal, but an improvement.

The second question that I was asked to address was whether the decline in international value of the dollar is going to succeed in shrinking the trade deficit, and, yes, it will, I think, slowly—perhaps too slowly.

Our impatience with the turnaround in trade is leading us back in the direction of fixed exchange rates, perhaps something that is referred to as target zones or reference ranges. One of the lessons that we should have learned in recent years is that fixed exchange rate systems do not produce fixed exchange rates.

The European monetary system, for example, has been realigned 11 times in its 8-year history and any similar system that would be set up to include the U.S. dollar it seems to me it would be more difficult to keep such a system in line.

So that in the end, I doubt that, whatever we do, we are going to achieve anything that is in practice and in its effect very different from the dirty float that we have been living with for the past dozen years or so.

Neither the 1987 outlook nor the trade deficit is as important in my mind as the long-term issue of economic growth. The latest buzz word in this connection is competitiveness, solutions for which are usually discussed in terms of protectionism or a falling dollar. Well, certainly it's possible for U.S. producers to sell on even terms against foreign manufacturers with the help of protectionism or currency depreciation—temporarily it's possible for them to compete on even terms, but either of those mechanisms leaves us with the underlying kind of failure that we have had over the past several decades and remains unsolved—a gradual but progressive deterioration in both our relative standard of living and our military and geo-political power around the world.

The solution to that problem is not to be found in protectionism or a depreciating currency, but only in a vigorous, long-term advance of productivity of the economy as a whole. We must learn to improve the productive efficiency of our work force at a rate comparable to the rest of the industrialized world.

How do we do that? Well, it's not easy to know. Economists' understanding of the basic determinants of productivity growth leaves an awful lot to be desired, but one prescription on which most economists would agree is to cut down current consumption and increase the total amount of saving and investment that is done in the economy that points toward enhancing future productivity.

On this score, the United States has a terrible historical record. Over the past half century, we have devoted a smaller share of our economic resources to new investment than almost every other major nation in the world and, correspondingly, we have had the slowest rate of growth in productivity and since the late 1960's the most pronounced slowdown in that trend.

To dramatize the importance of persistent advances in productivity, we can make the calculation that if the trend of productivity growth that prevailed prior to 1967 had continued unabated, today every American family would have a level of income over 40 percent higher than it has now. I think that's a rather dramatic kind of number and an indication that that shortfall is basically a measure of the enormous costs we have incurred by our inability to keep productivity advancing smartly since the mid-1960's.

What policies can we adopt to encourage productivity-enhancing saving and investment? Well, one major change has already been enacted—the Tax Reform Act of 1986—with the lower marginal tax rates that are embodied in that legislation. I think that's a definite step in the right direction. We will not know for sure how much or how little that will do to enhance savings and investment for some years. We won't know that, but it's a bold step for which I think both the President and the Congress deserve much praise.

Another policy step in the direction of higher national savings is to do something meaningful about the Federal budget deficit, which is a major subtraction from the meager supply of savings that are available to finance new plant and equipment spending.

This dissaving is usually talked of in terms of representing 4 percent of GNP. A more appropriate comparison, however, is to note that it represents 50 percent of the savings used to finance net additions to our capital stock, and that statistic it seems to me gives us a better feeling for how serious a matter this deficit that we're running is in terms of its drain on our growth potential.

Eliminating the deficit is, of course, not an easy matter. The political costs of cutting spending and raising taxes are widely appreciated. Furthermore, in a democratic system of government like ours, it is always difficult to come to grips with a situation where a problem that is not stark and imminent—if we're not falling off a cliff somehow we're not willing to do anything about it—and in this case, the economic decay we face is particularly vague and remote. The damage caused by large budget deficits is corrosive, not explosive.

But neither the difficulty in dealing with the deficit nor the insidious way that it undermines our economic health makes it any less destructive in the end, and the budget deficit I believe deserves our serious attention now.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Fiedler, together with an attachment, follows:]

PREPARED STATEMENT OF EDGAR R. FIEDLER

Almost all the economic forecasts for 1987 discussed before this Committee in recent weeks, including the Administration's forecast, have fallen within a narrow range that represents a reasonable expectation for the year ahead. With few exceptions, the differences are not worth debating. The petulant quibbling in which we so often engage over minor differences in forecasts fully justifies the public stigma regularly encountered by both economists and politicians.

If anything, the latest signs and portents show an improving outlook, both here and around the world. Attached is the latest issue of The Conference Board's International Economic Scoreboard, which shows a strengthening of the business cycle in most industrial nations.

Even without improvement, most complaints about the recent and prospective performance of the United States economy are exaggerated. The economy is doing better than it is given credit for. The present unemployment rate is not the best that can be achieved without igniting a new inflationary conflagration, but it is reasonably close to the optimum level. Similarly, the 3-4 percent inflation expected for 1987 is not the best that can be achieved without another long bout of high unemployment, but it is reasonably close. The combination of 6½-7 percent unemployment and 3-4 percent inflation represents an acceptable compromise. We ought to realize when we are well off.

A second question given wide attention in these hearings is whether the decline in the international value of the dollar will shrink the trade deficit in 1987. I believe it will, slowly--perhaps too slowly to satisfy most of us. If the trade balance does not fall, sooner or later the dollar is likely to decline further. Many seem to regard this as an unacceptable prospect. But is there a good alternative?

The opinions expressed here are the author's and should not be attributed to The Conference Board or any other organization with which he is affiliated.

We hear much about achieving exchange-rate "stabilization" (a word that seems useful mostly for its ambiguity). What people usually have in mind is some kind of fixed rate system, perhaps in the form of "target zones." The advantage is said to be an environment that provides greater stability and certainty for those who deal in international markets. Well, fair enough, but if we have learned one thing in recent years, it is that a fixed exchange rate regime does not ensure fixed exchange rates. The European Monetary System, for example, has been realigned eleven times in its eight-year history. Any such system that also included the U.S. dollar would be even more difficult to keep in line. In the end, I doubt we would achieve anything very different from the "dirty floating" exchange rate system we have been living with over the past dozen years.

Longer Term Performance

I turn now from short-run policy matters (on which our attention is too often exclusively focused) to the more important longer range issue of economic growth. The latest catchword in the discussion of economic policy is "competitiveness"--the ability of U.S. producers to compete in world markets--something that has been conspicuously absent in recent years. Unfortunately, many policy analysts would evidently be satisfied to achieve competitiveness for U.S. producers by means of either protectionism or a declining international value of the dollar.

Either method, it is true, will enable U.S. producers to sell on even terms against foreign manufacturers, temporarily. But a temporary competitive balance achieved by protectionism or currency depreciation does not solve the underlying problem. It leaves us with exactly the same serious economic failures we are currently experiencing: a gradual but progressive deterioration in both our relative standard of living and our military and geopolitical power in the world.

The solution is not to be found in the currency value or in restraint of trade, but in productivity. To achieve and maintain a truly competitive position in the world, the U.S. must persistently improve the productive efficiency of its workforce at a rate comparable to other major nations of the world. There is no other solution.

How do we accomplish this? Hard to say. Our ability to understand the long-run determinants of productivity growth is severely limited. Indeed, we are not even sure we can measure productivity accurately. It seems clear, however, that one of the most important sources of productivity growth is the extent to which a society is willing to forego the satisfaction of current consumption in order to devote resources to future-oriented saving and investment.

Over the past half-century, the United States has devoted a smaller share of its economic resources to saving and investment than almost every other major industrial nation. Correspondingly, the United States has recorded the slowest rate of growth in productivity, and also the most pronounced slowdown in productivity growth over the past two decades. To dramatize the importance of a persistent vigorous advance in national productivity, we can calculate that if the pre-1967 productivity trend in the United States had continued unabated, the typical American family today would enjoy an income some 40 percent higher than it now earns. That shortfall is a measure of the enormous cost we have incurred by our inability to keep productivity advancing smartly since the mid-1960s.

What policy actions might we take to encourage the kind of saving and investment that will elevate our productivity trend? One major change has already been enacted, namely the reduction in marginal income tax rates embodied in the 1986 tax reform legislation. The President and Congress deserve much praise for that step. Although we will not know for some years how much or how little impact tax reform will have on saving and investment, the legislation is a bold effort that deserves high marks.

Another policy step in the direction of increased national saving would be to do something meaningful about the Federal budget deficit. The deficit represents a major subtraction from the meager supply of savings otherwise available to finance new productivity-enhancing investment. This dissaving is often expressed as representing 4 percent of GNP. A more appropriate comparison, however, is to note that a deficit of this size represents 50 percent of the savings that would otherwise be available to finance net additions to the capital stock in our economy. That statistic gives a better feel for how serious a matter the deficit is in terms of a drain on our growth potential.

I do not mean to suggest that eliminating the deficit is an easy matter. The political costs of cutting expenditures and raising taxes are widely appreciated. Furthermore, a democratic system of government always has difficulty coming to grips with a problem that is not stark and imminent. In this case, the economic decay in store for us seem especially vague and remote; the damage caused by large budget deficits is corrosive, not explosive. But neither the difficulty of dealing with the deficit nor the insidious way it undermines economic progress makes it any less destructive in the end. The deficit deserves our serious attention now.

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A Monthly Report from The Conference Board

INTERNATIONAL ECONOMIC SCOREBOARD

The Conference Board

JANUARY, 1987

SUMMARY

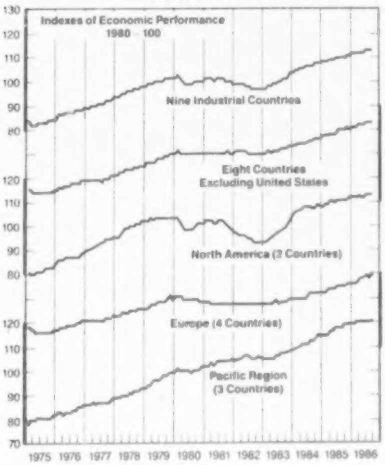
Good wishes for the New Year is the message from the leading indicators for the nine major industrial countries. Growth rates of 6 percent or above are reported by the leaders for the United States, West Germany, France, Italy, Japan, Australia and Taiwan, R.O.C. In Canada and the United Kingdom the growth rates are positive but modest. The 9-country leading index growth rate has hit 6 percent for two months in a row, a more vigorous rise than at any time during the past two years.

The economic performance indexes, which usually lag a few months to a year or so behind the leading indexes, reflect very sluggish expansions in Canada, the United Kingdom, Italy and Japan. Growth in these measures of output, employment and income remain modest in the United States, West Germany, France and Australia. Taiwan is well ahead of the rest with a growth rate of 11 percent in its performance index, matching the rate first observed about a year ago in its leading index.

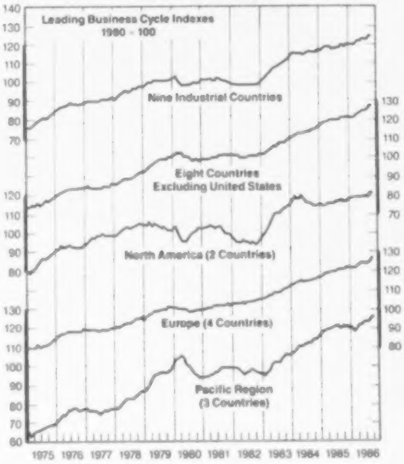
	Ten-year Growth	*Indexes of Economic Performance Growth Rates**			*Leading Business Cycle Indexes Growth Rates**				
	Rate 1969-79	*6 mos ago*	*3 mos. ago*	*Latest month*	*6 mos. ago*	*3 mos. ago*	*Latest month*	*Current Reading on the Cycle*	*Latest Month Covered*
		annual rates, percent							
9 countries	4	4	3	3	4	4	6	Expansion continuing	Oct.
8 countries ex. U.S.	4	3	3	3	4	5	6	Expansion continuing	Oct.
North America (2)	3	4	2	2	3	3	5	Expansion continuing	Oct.
Europe (4)	3	4	4	4	5	5	6	Expansion continuing	Oct.
Pacific Region (3)	5	2	1	2	2	6	6	Expansion stalling, leaders strong	Oct.
United States	3	2	2	2	2	1	7	Expansion continuing	Nov.
Canada	4	4	1	1	4	3	4	Expansion stalling	Oct.
West Germany	3	5	6	4	6	4	6	Expansion continuing	Nov.
France	4	4	4	4	7	8	9	Expansion continuing, leaders strong	Oct.
United Kingdom	2	2	1	1	0	1	1	Expansion stalling	Oct.
Italy	3	1	3	-1	10	9	8	Expansion stalling, leaders strong	Aug./Sept.
Japan	5	1	1	1	2	5	6	Expansion stalling, leaders strong	Oct.
Australia	4	4	2	3	-1	3	9	Expansion stalling, leaders strong	Oct.
Taiwan, R.O.C.	10	8	10	11	13	14	15	Expansion continuing, leaders strong	Nov.

* Ratio of current month's index to average index over the preceding 12 months, expressed as a compound annual rate.

Where We Are



Where We're Headed



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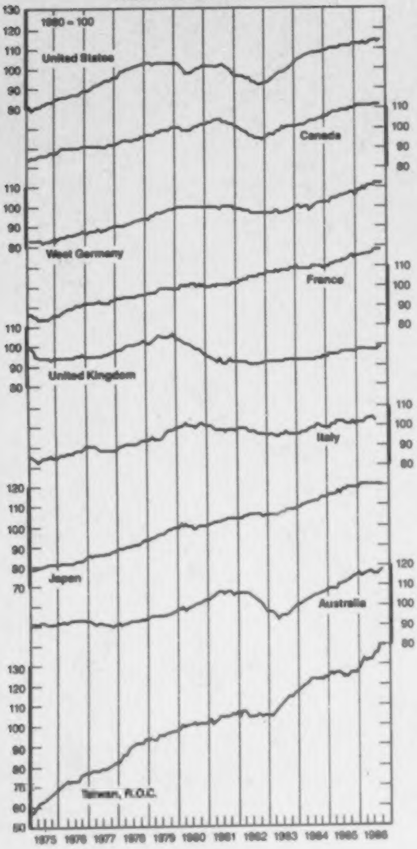
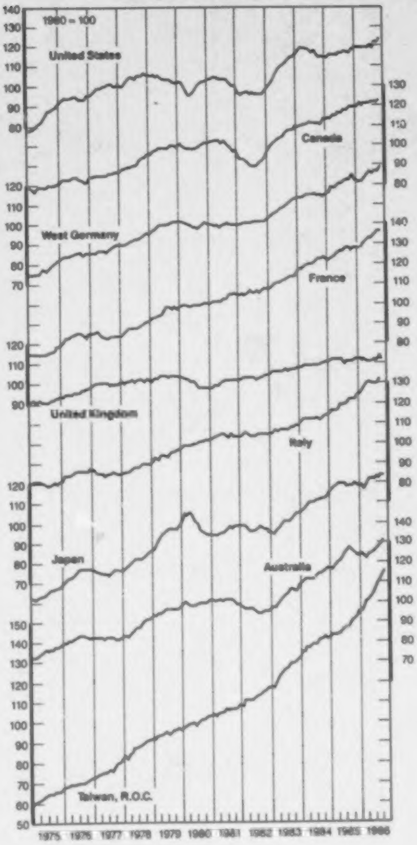
Where We Are

Indexes of Economic Performance

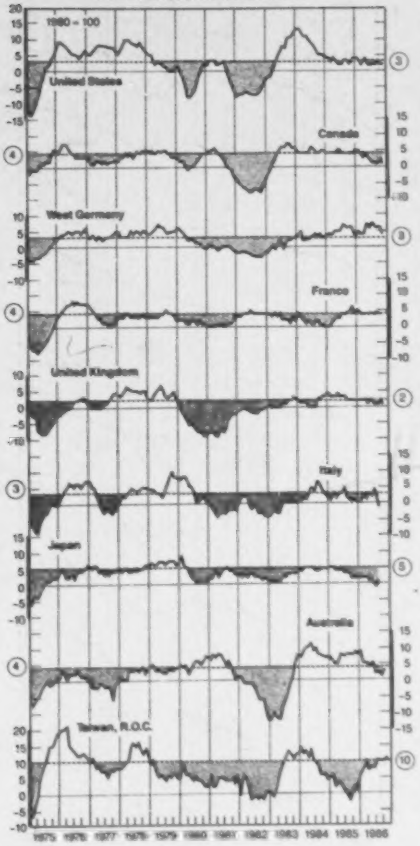


Where We're Headed

Leading Business Cycle Indexes

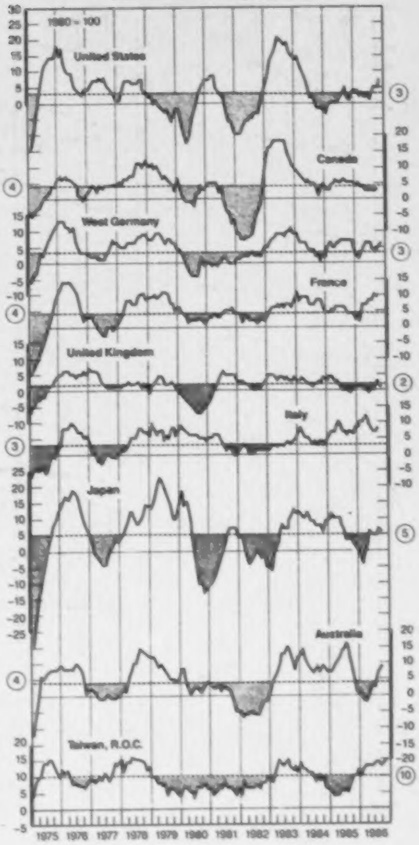


Sources: CIBCR and The Conference Board.



Where We Are

Growth Rates, %, Performance Indexes



Where We're Headed

Growth Rates, %, Leading Indexes

Note: Horizontal dashed lines are average rates for 1969-79 in the index and in Real GNP.

Sources: CIBCR and The Conference Board

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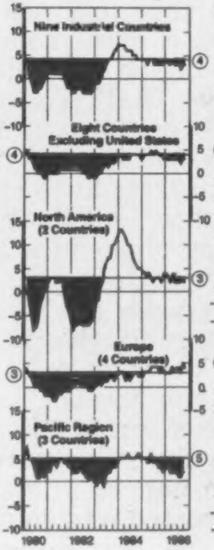
INDEXES, NINE COUNTRIES, 1985-86

		U.S.		Canada		West Germany		France		U.K.		Italy		Japan		Australia		Taiwan, R.O.C.	
		Indexes, 1980 = 100																	
		Perf.	Lead.	Perf.	Lead.	Perf.	Lead.	Perf.	Lead.	Perf.	Lead.	Perf.	Lead.	Perf.	Lead.	Perf.	Lead.	Perf.	Lead.
July	85	110	117	108	117	108	121	113	127	97	111	103	119	118	119	112	126	125	148
Aug.	85	111	117	109	118	108	122	113	128	97	111	102	120	118	118	112	128	124	149
Sept.	85	110	118	109	118	108	123	113	129	97	111	101	121	119	119	113	127	125	151
Oct.	85	110	117	109	119	107	123	114	127	97	111	101	122	119	120	114	125	126	153
Nov.	85	111	117	110	119	107	124	115	128	97	111	102	122	119	119	115	124	126	154
Dec.	85	112	118	110	119	108	123	114	128	97	112	101	124	119	118	115	123	127	156
Jan.	86	112	119	111	119	108	122	115	128	98	112	102	125	119	119	116	124	130	158
Feb.	86	112	119	111	121	108	122	115	128	98	112	102	126	120	116	115	123	132	159
Mar.	86	112	119	111	120	108	123	115	130	98	112	102	127	120	117	115	122	133	161
Apr.	86	113	119	112	121	110	125	116	132	98	111	102	129	120	120	116	124	132	162
May	86	112	119	111	121	109	126	116	133	98	111	104	130	120	122	116	124	133	164
June	86	112	119	111	121	111	127	116	133	98	111	103	129	120	122	117	126	135	166
July	86	113	120	111	122	111	128	117	134	98	112	104	129	120	123	116	127	136	166
Aug.	86	113	119	111	122	111	127	118	136	98	111	102	130	120	122	116	128	136	170
Sept.	86	114	122	112	122	112	127	118	137	99	114		132	120	124	116	129	136	171
Oct.	86	113	122	112	123	112	128	118	137	99	112			120	124	118	131	140	174
Nov.	86	114	124			112	129											140	176
		Growth Rates, Percent																	
July	85	2	2	4	5	7	7	4	6	3	0	5	7	5	6	8	15	−1	6
Aug.	85	3	3	4	6	6	7	4	6	2	0	2	7	4	3	8	16	−2	5
Sept.	85	3	5	4	5	6	7	3	5	2	0	1	7	3	4	8	11	−1	8
Oct.	85	2	2	4	5	6	7	4	4	2	−1	0	7	3	4	8	7	2	10
Nov.	85	3	1	4	5	5	7	6	4	2	0	1	6	2	2	9	4	1	10
Dec.	85	4	3	5	5	3	4	4	3	2	1	0	8	2	1	7	1	2	12
Jan.	86	4	4	5	4	5	3	5	3	2	1	0	8	2	0	9	1	8	10
Feb.	86	3	4	4	5	4	1	4	2	2	1	1	10	2	−4	5	−1	8	12
Mar.	86	2	2	3	4	4	3	4	5	2	2	2	10	2	−2	5	−2	10	13
Apr.	86	4	3	4	4	7	5	4	7	2	0	1	12	1	2	4	−1	7	13
May	86	2	2	3	3	5	6	4	7	1	0	3	11	1	4	4	0	8	13
June	86	2	2	2	3	7	6	4	7	2	−1	2	9	2	6	5	3	9	13
July	86	2	3	1	3	7	4	4	8	1	1	4	7	1	5	2	3	10	14
Aug.	86	2	1	1	3	6	4	4	8	1	0	−1	7	1	5	2	5	10	14
Sept.	86	3	5	2	3	6	4	4	10	2	3		8	2	7	1	7	10	18
Oct.	86	2	5	1	4	5	5	4	9	1	1			1	6	3	9	11	14
Nov.	86	2	7			4	6											11	15
		Ten Year Annual Growth Rate, Percent																	
1969-79		3	3	4	4	3	3	4	4	3	3	2	2	5	5	4	4	10	10

		9 Countries		8 Countries ex. U.S.		North America (2)		Europe (4)		Pacific Region (3)	
		Indexes, 1980 = 100									
		Perf.	Lead.	Perf.	Lead.	Perf.	Lead.	Perf.	Lead.	Perf.	Lead.
July	85	110	119	110	120	110	117	106	120	118	121
Aug.	85	110	119	110	120	110	117	106	121	118	120
Sept.	85	110	120	110	121	110	118	105	121	118	121
Oct.	85	110	120	110	121	110	117	106	121	118	121
Nov.	85	111	119	111	121	111	117	108	122	119	121
Dec.	85	111	120	110	121	112	118	106	122	119	120
Jan.	86	112	120	111	121	112	119	106	122	119	120
Feb.	86	112	120	111	121	112	119	106	122	119	119
Mar.	86	112	120	111	122	112	119	107	123	120	119
Apr.	86	112	122	112	123	113	119	108	124	120	122
May	86	112	122	112	124	112	119	108	125	120	123
June	86	112	122	112	125	112	120	108	125	120	124
July	86	113	123	113	125	113	120	108	126	120	124
Aug.	86	113	123	113	125	113	119	108	126	120	124
Sept.	86	113	125	113	126	113	122	109	127	120	125
Oct.	86	113	125	114	127	113	122	109	128	121	126
		Growth Rates, Percent									
July	85	4	4	5	6	3	3	5	5	5	7
Aug.	85	4	4	4	5	3	3	4	5	4	5
Sept.	85	3	5	4	5	3	5	3	5	4	5
Oct.	85	3	4	4	5	2	3	4	4	3	5
Nov.	85	3	3	4	4	3	2	4	4	3	3
Dec.	85	3	3	3	3	4	3	3	4	3	1
Jan.	86	4	3	3	2	4	4	3	3	5	1
Feb.	86	3	2	3	1	3	4	3	3	3	−3
Mar.	86	3	2	3	2	2	2	3	4	2	−2
Apr.	86	4	4	3	4	4	3	4	5	2	2
May	86	3	4	3	5	2	2	3	6	2	4
June	86	3	4	3	5	2	2	4	5	2	6
July	86	3	4	3	5	2	3	4	5	1	6
Aug.	86	2	3	2	5	2	1	3	5	1	5
Sept.	86	3	6	3	6	3	5	5	6	2	7
Oct.	86	3	6	3	6	2	5	4	6	2	6
		Ten Year Annual Growth Rate, Percent									
1969-79		4	4	4	4	3	3	3	3	5	5

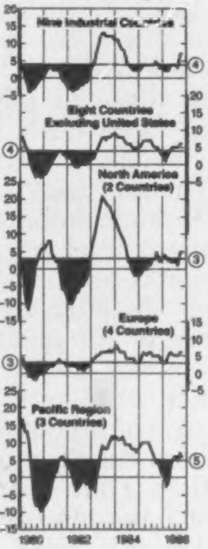
Where We Are

Growth Rates, %, Performing Indexes



Where We're Headed

Growth Rates, %, Leading Indexes



Note: Horizontal dashed lines are average growth rates for 1969-79 in the index and in real GNP.
Sources: CIBCR and The Conference Board

Senator **Sarbanes**. Thank you very much.

Mr. Hormats, please proceed.

STATEMENT OF ROBERT D. HORMATS, VICE PRESIDENT, GOLDMAN SACHS & CO.

Mr. **Hormats**. Thank you, Mr. Chairman.

I have put forward a number of thoughts in my prepared statement. In the oral part of my testimony I will focus on a few key points prompted by some recent thoughts I have had regarding the Economic Report of the President.

On the whole, I think it's a very well done report and reveals what what I believe to be a number of particularly useful points regarding the U.S. economic outlook.

First, it is important to recognize that in most projections of U.S. economic growth the trade outlook tends to be a swing factor. That is to say, one's view of U.S. economic growth would change quite dramatically depending on one's assumptions about the U.S. trade deficit for 1987.

Much of the work of this Congress this year is going to be one way or another focused on the economy. Trade is, as you know, Mr. Chairman, one of the important elements of the congressional agenda.

My own guess is that we are going to see some improvement in the U.S. trade balance this year. It's awfully hard to project what that might be. But a reasonable guess is that our trade deficit will decline by something on the order of $20 or $25 billion from its historic highs of 1986. That's an improvement, but it's not enough to turn cartwheels over, because it still leaves us with the largest trade deficit we've had for any given year but one.

The currency markets have reflected continued concern over the U.S. trade imbalance, and I suspect that unless one sees the trade deficit corrected by virtue of a greater change in relative domestic demand between the United States and its major trading partners, then the currency rates are going to have to continue to take the brunt of the pressure for that adjustment.

We are seeing markets react on a day-to-day basis to what finance ministers and treasury secretaries say. Over the medium term, the major concern is still what appears to financial markets to be a very large and still stubborn U.S. current account and trade deficit. That is an important element of the U.S. economic outlook that has been discussed well in the Economic Report.

Another point that was discussed in the report, and one that I think bears emphasis yet again, is the importance of trade negotiations not as a vehicle for correcting the U.S. trade balance, because the trade imbalance is largely the result of macro forces rather than specific trade problems, but as a vehicle for addressing specific sets of trade problems with other countries. The report indicates ways in which those can be addressed.

This Congress has before it a number of proposals for trade legislation. Doubtless, there will be a number of other ideas suggested over the next several months. A bipartisan trade bill agreed between the executive branch and the Congress is important in terms of the credibility of America's negotiators and because we have not really had a consensus on trade in this country for the last 7 or 8 years. Absent a consensus, it becomes very hard for this country to focus its energies and its attention on dealing with what are surely important trade problems.

The third area that the report touches on is the enormous distortion in world agriculture. I put in my prepared statement, Mr. Chairman, some figures that would shock one who's concerned about the prudence of government spending. For every dollar received by a Japanese farmer, consumers and taxpayers there pay $2.50. For the European Community, for every dollar received by a European farmer, taxpayers and consumers pay $1.50. In the United States, the comparable figure is $1.38. These figures indicate that there is an enormous amount of waste in our agricultural programs which don't benefit the farming community. And if there is one area where we have collectively shown an absence of a willingness to get to the heart, it is the inability of the industrialized countries to deal with the egregious distortions in agriculture.

A point I would also make, because it's a topical one, relates to the concerns that are frequently expressed in the newspapers and on television and among some politicians about the inflow of foreign investment into the United States. I would simply say that a country which is borrowing a lot more than it is saving is going to have to get the capital from somewhere. It is getting the capital from the biggest saving countries in the world, which are today Japan and West Germany. That investment from abroad comes in a lot of ways. It comes through their purchases of government debt. It comes in the area of direct investment. And it comes in the area of equity investment.

It strikes me that not only is this direct investment inevitable for a country which has to import capital, but by and large it creates jobs and brings new technologies and new management techniques. It is an infusion of stimulus into certain sectors of the American economy. Obviously it has to be done in a sensitive way, and some foreign investment is not without problems. But by and large it is something that we have to accept as a reality, and basically as a positive thing.

I would also remind us as a country that when one looks at direct investment, as late as 1981 the United States had a net direct investment position abroad of $119 billion. So that the amounts we're talking about today in net terms really don't come close to what the United States had a few years ago.

I would, finally, point out that the adjustment in the world economy over the next several years is going to be quite painful. Adjustment is going to occur. No country can have a perpetual current account deficit. Over a period of time that has to change. The real political issue and real economic issue is, does that change as the result of an orderly set of policy adjustments by the major economies, including our own, or does it change in an environment of trade disruption, of protectionism, and currency volatility?

It seems to me it is imperative that the West summon the wisdom to ensure that the change is done in an orderly way. I would simply point out that in 1971, when there was a large U.S. imbalance, there was a general agreement among the industrialized countries on the magnitude of the correction required.

Today, I fear that we really don't have even that much consensus and until there is some general underlying consensus on how the adjustment is to take place and over what period of time, I'm afraid we're going to force a lot of disruption.

Thank you, Mr. Chairman.

Senator **Sarbanes**. Thank you very much.

[The prepared statement of Mr. Hormats follows:]

PREPARED STATEMENT OF ROBERT D. HORMATS

Mr. Chairman:

I am grateful for the opportunity to testify at this series of hearings on U.S. international economic policy.

Fifteen years ago, a $4 billion US trade deficit -- the first for the US after World War II -- caused President Nixon to impose a 10% import surcharge and terminate convertibility of the dollar into gold. Toward the end of last year, the US recorded trade deficits of nearly $4 billion in an average week. Even allowing for inflation, that is an astonishing increase.

A very junior staff member of the National Security Council staff in 1971, I still recall the shock in Congress and the executive branch at the deterioration in the US trade position that had led to this first post-war trade deficit as well as the quickness with which so many blamed this problem on the rest of the world. Equally striking was the tendency of other nations to place the blame almost entirely on the US and their reluctance to see the weakened US trade position as an international problem requiring a multilateral solution.

The present US trade deficit is more dangerous than in 1971. And, we now also have an enormous current account deficit. Unless these begin to decline soon, the US will face an external debt of over $700 by 1990, intense demands for new trade restrictions, and Congressional pressures for troop cuts abroad. Like 1971, however, too much discussion has been focussed on assigning blame and too little on addressing the fundamental reasons for this imbalance.

The central question today is not whether the US current account deficit will be reduced. It will be -- because it is both economically and politically unsustainable! As assuredly as Newton's Law applies to physics, so does the law of inevitable correction of imbalances apply to economics. No country can have a permanent current account deficit. Indeed, ultimately the US must run a trade surplus simply to pay the interest on the debt already incurred. The central question is whether the US deficit will be reduced in an orderly way -- by a combination of currency changes, higher domestic demand abroad, and lower budget deficits at home -- or in a disorderly way, in an environment of volatile currencies, protectionism, and lower growth.

But there are longer term questions as well: How does this country position itself for future? How does the US structure its economy to compete more effectively in the world? How do we use the coming multilateral trade negotiations -- probably the last in this century -- to build a more open international economy? And how do the major economies promote growth and create new jobss while avoiding currency and trade imbalances in the future?

At stake in the current trade debate is not just this nation's trade balance in 1987 but the position of the US in the world economy for years to come, prosperity in the US and most other nations, and the cohesion of alliances vital to US security.

Bearing this in mind, we must recognize that it took several years for the US to get into its present trade difficulties and it will take time to get out. And part of the cause of this problem lies within our own borders. Attempts at trade restrictive, short-term solutions will merely lead to frustration and could seriously harm prospects for attaining longer term US goals.

RECENT DISAPPOINTMENTS

When the dollar began its fall toward the end of 1985, there were high hopes that the US trade deficit would soon decline. Instead, the deficit has risen. The dollar's fall has failed so far to reduce our trade deficit for several reasons:

--the dollar was too strong for too long, causing US companies to lose foreign market share and locate more production abroad while companies in other nations were able to gain a strong market foothold in the US;

--although the dollar has fallen, that decline has not extended to currencies of some important US trading partners; moreover the price of imports from even those countries against whose currencies the dollar has fallen has risen quite slowly and the foreign currency price of US exports in such countries has fallen only recently. This has retarded the expected decline in US orders for foreign-made goods and the pick up in foreign orders for US goods;

--sluggish growth in major industrialized countries has limited their imports of American goods; many of these countries find it hard to break the pattern of reliance on exports for a significant portion of their economic growth;

--the continued excess of US private and government borrowing over US domestic savings requires a massive inflow of capital from abroad; that permits consumption and investment spending in the US at levels that draw in more imports than would take place absent a large savings-investment gap.

--poor economic performance and severe debt constraints on growth in Latin America and other Third World countries together slow their demand for imports and induce them to artificially boost exports; the major trade impact falls on the US.

--foreign trade barriers continue to harm sectors of the American economy. But, although their removal should be a major US priority, they are not the major reason for the enormous magnitude of the trade imbalance the US now faces, and simply eliminating them without a proper alignment of currencies, higher growth abroad, and a reduction in our domestic imbalances will do little for our overall trade position.

--disappointing American productivity is troublesome because it means that some sectors of the US economy are not in a strong position to take advantage of the dollar's decline or lower trade barriers abroad.

A DISCUSSION OF THESE PROBLEMS

Before turning to policy recommendations, I will briefly examine some of the underlying causes of these problems.

First, what portion of this country's trade imbalance is home made?

Second, to what extent have the policies of this country's industrialized country partners and the problems of cooperation among the major democracies contributed to US trade difficulties?

Third, what part has high Third World debt played in the deterioration of the US trade position?

DOMESTIC POLICY ISSUES

At the heart of America's trade problem is the failure of this nation to maintain a balance between its financing demands and its level of savings. The difference is met by imports of capital that lead to a higher level of imports than would occur if this country saved enough to meet its borrowing needs (or alternatively, cut its borrowing to more closely match its savings rate). In short this country is living beyond its means -- importing enormous amounts of capital from abroad and the goods that this capital finances.

Three sets of figures illustrate the point.

The first set shows just how much the debt of key US sectors has climbed in recent years. From 1980 through 1985 debt of households increased from 51% of GNP to 59% of GNP; business debt rose from 50% of GNP to 58% of GNP; and federal debt shot up from 26% of GNP to 39% of GNP -- nearly two times the increase of the other two.

The second set illustrates how this increase was associated with a large gap between savings and investment. During the period from 1961-1970 US personal savings averaged 4.7 percent of GNP while corporate savings averaged 3.3% of GNP. Combining the two, the US realized an average net private savings rate of 8% of GNP. The Federal deficit then averaged about .5% of GNP. Thus, total net savings averaged about 7.5% of GNP. Net domestic investment was usually about 7% of GNP. So the US could export capital amounting to about .5% of GNP, That, in effect, helped other countries to buy US goods and services -- so we had a small current account surplus during that period.

By 1985 annual personal saving had slipped to 3.3% of GNP, and corporate savings to 3.2%, for a net private savings rate of 6.5%. But the federal deficit had grown to roughly 5% of GNP. Even including state and local government surpluses (totaling 1.4% of GNP) that adds up to a total net savings level for the US of 3% of GNP. As net private domestic investment added up to 5.7% of GNP, the US had to borrow over 2.7% of GNP from the rest of the world. That borrowing -- causing the value of the dollar and US imports to surge -- was the mirror image of our current account deficit in 1985 of $117 billion.

The last set of figures compares US savings/investment/current account performance with other countries. From 1971 through 1979 US gross domestic investment was nearly 17% of GNP while gross domestic savings averaged 16%; in 1985 gross domestic investment was the same 17 % of GNP while gross domestic savings (private savings minus the government deficit i.e. government "dissaving") had fallen to roughly 14%. That gap, as noted, was associated with the rise in the dollar and in the US trade and current account deficits. In contrast, Japan and Germany throughout this period recorded gross savings levels well above gross domestic investment (which in part can be accounted for by relatively slow growth in those nations) -- leading to substantial amounts of savings available for them to export. That excess was borrowed by large capital importers such as the US -- helping it to finance its rising levels of imports.

A significant portion of the inflows of foreign capital that occurred after 1982 did so because US banks slowed lending to developing countries and increased it at home while continuing to attract funds from abroad (thus increasing their net inflows from abroad). And some funds came to the US to take advantage of investment opportunities in the private sector. Some of these flows occurred because tight money policy in the face of expansive fiscal policy raised interest rates to attractive levels.

A 1986 Commerce Department report underscores the link between the federal deficit and trade: "The critical element in producing these imbalances was the uninterrupted expansion of the federal budget deficit from about $60 billion in 1980 to over $200 billion in 1985. Absent the very large government deficits, private saving probably would have been more than adequate to meet US investment needs, the dollar exchange rate would probably have been lower, and the net foreign capital inflows and the accompanying very large current account and trade deficits probably would not have occurred."

My intention here is not to burden the Committee with statistics, but to underscore the point that this country will confront continuing imbalances so long as it suffers from a large domestic savings-investment imbalance.

Moreover, the recent string of large current account deficits has caused the US to build up a net foreign debt which by 1990 will require this country to spend more than 1% of our GNP just to pay interest abroad and over time could make investors less willing to hold dollar securities. (Ultimately, of course we will need a trade surplus simply to pay that interest or else we shall have to borrow funds abroad for that purpose, as many Latin Anerican nations must do today.) Increasingly the level of investment, consumption and interest rates in the US has come to depend on foreign capital. In 1985, for example, fully 44% of net new Treasury financing in long-term bonds was purchased by Japanese institutions. There is a serious financial risk in this enormous US appetite for capital. Should new fund flows to the US abate, American interest rates would rise and domestic growth would slow because government and private sector would have less money to finance their borrowing needs. And, the need for foreign capital complicates the job of the Fed; a pullback by foreign investors in dollar securities that triggers a sharp drop in the dollar might suggest the need for an increase in US interest rates while the weakness of the US economy would argue strongly against that course. The Fed would be in a difficult position.

I do not accept the notion that it is inevitable that foreigners will at some point dump dollars in such large amounts that the currency will collapse. Indeed Europe and Japan still have only about 5%-10% of their financial assets in US dollar assets -- hardly a figure which would cause them to feel that their portfolios were saturated with dollars. But they could, from time to time, refrain from buying dollar securities if they anticipate a continued fall in the dollar or a rise in US inflation; in so doing they would hasten the dollar's decline, push up the price of imported and ultimately domestic goods, and drive up interest rates in the US. A similar sharp weakening of currencies, dramatic reduction in domestic economic activity and surge in inflation, it may be recalled, happened to Britain in 1976 and in most of Latin America in the early 1980s. We cannot assume that because the US is big and has a strong economy -- or that because our debt is in our own currency rather than someone elses -- we are completely immune from these potential adversities.

A second troublesome aspect of the US domestic situation is highlighted in the Report of the President's Commission on Industrial Competitiveness -- the growth of US productivity has been low compared to that of other major countries. This is highly disturbing but not surprising when one considers the subpar US performance in three critical factors that determine productivity: our educational system by most tests is not performing as well as those of Japan, West Germany, or other countries of Europe; civilian research and development expenditures are lagging behind those of our major trading partners; and, low savings and high government demands on those savings that are available mean that the cost of capital in this country tends to be higher today than abroad. To be sure these negatives have in part been offset by growing emphasis on research by the US private sector, links between corporations and universities to pioneer new technologies, welcome progress in deregulating key sectors of the economy and greater latitude by the Justice Department in allowing mergers and acquisitions. But without getting the fundamentals right on education, savings, and research and development spending the US will compete in the race for the future with one foot stuck in the starting gate.

There is also the question of a sustained national commitment to exports. Old attitudes die hard. American industry has increasingly come to recognize that its survival depends on meeting international competition. This has been recognized only slowly in some cases because of the habit of relying heavily on the large American domestic market -- but most US companies today have active strategies for meeting foreign competition by improving the efficiency of production in the US, locating new plants abroad, or developing cross border research, production and distribution alliances.

The real lag here is in the US government. In the last twenty years administrations of both parties have imposed economic sanctions which hurt American companies without accomplishing the intended foreign policy goals. Exports of soybeans, grain, oil equipment and other items have been the targets of this folly. Permanent damage was done to American exporters. The Defense Department today still has trouble in recognizing that the US is not the only source of much of the "grey area" equipment it wants Americans to stop selling abroad. And it hurts US high companies by excessive restrictions on their sales of technology even to Western nations. Moreover, it was only in the fall of 1985 -- thanks to Secretary Baker -- that the administration recognized how harmful the strong dollar was to US companies and did something about it. Even now the Export Import Bank has to battle for fundswithin the administration.

We have also failed to develop a national consensus on trade policy that we can project internationally. The President has paid insufficient attention to the subject and has failed to forcefully advocate US positions with foreign leaders. Intense differences have been allowed to fester unresolved in the administration. The White House and the Congress have not communicated well on this subject thereby causing other nations to question whether US negotiators have sufficient political backing. Leaders of American business and labor have for several years felt that their trade interests have not been put forward strongly enough in international forums. Many feel we have been "sitting on our rights" in the GATT while other nations have been actively their trade interests forcefully in bilateral talks using political leverage.

PROBLEMS AMONG THE INDUSTRIALIZED DEMOCRACIES

Although much of the US trade problem is rooted in imbalances and inadequacies of this nation's own domestic performance and policy, a part must surely be attributable to economic problems in our major Western trading partners and failures in economic cooperation among industrialized democracies.

Western governments have not yet fully digested the magnitude of recent changes in the world economy -- changes that necessitate a better harmonization of underlying policies and significant efforts to avoid currency distortions. Billions of dollars, yen and deutschemarks are exchanged daily on world currency markets; the greater the divergence among national economic policies and performance, the greater the chances of currency volatility and misalignments. That in turn can lead to major and prolonged trade imbalances of the type we are now experiencing.

As national capital markets have become closely integrated, economic sovereignty has been sharply diminished. Yet governments have not devised ways to exercise shared sovereignty. Their policies, as today, frequently work at cross purposes. Attempts to achieve policy compatibility -- such as the coordinated effort to realign currencies decided on at the Plaza Hotel in September. 1985 or the parallel lowering of interest rates early in 1986 -- are usually made after periods of currency instability or sizeable trade imbalances when leaders have little choice. Governments have appeared content to try to deal with such problems after the fact; they have had trouble in summoning the foresight or the will to avoid them.

Second, shifts in global economic strength have not been matched by changes in attitude or habits. The US is a debtor country that still behaves as if it were a creditor; and Japan and Germany are creditor countries that cannot break habits developed when they were debtors.

Popular opinion in the US has not yet come to grips with the notion that we cannot continue indefinitely as a large external borrower. Moreover, it is hard to lecture other nations -- particularly West Germany and Japan -- on economic policy as long as this country cannot come to grips with its domestic deficit.

Japan and much of Europe were slow to recognize that the days when they could argue that their trade barriers and subsidies should be tolerated by the world because they were small countries and their actions could not really hurt the international economic system -- while the US, because of its size and impact on the international trading system was urged to practice a special form of discipline -- are long since over. But popular opinion in these nations has not yet come to terms with the notion that the long term interest of their societies will be served by their assuming a greater portion of the global economic management role that the US took on after World War II.

Third, the industrialized democracies have tended to use annual Economic Summits and similar gatherings to press one another for short-term policy improvements -- i.e. for "fine tuning" -- rather than to achieve a meeting of minds on consistent medium-term growth and balance of payments strategies. To have done so might have enabled leaders to chart steady and internationally compatible courses at home. Sharp differences in national savings and government borrowing, conflicting monetary policies, and other divergencies will breed currency and trade problems.

Forth, these governments have allowed the GATT to fall into disrepair. A series of bilateral arrangements to restrict trade, widening subsidies, and growing disregard for the rules has condemned the world to an escalating series of trade problems. One of the most egregious distortions has occurred in agriculture. Taxpayers in the US, Europe and Japan pay billions for agricultural subsidies and consumers -- through propped up prices -- pay billions more. But only a portion of these funds gets to farmers. A recent study by the Department of Primary Industry in Australia points out that in Japan consumers and taxpayers lose $2.50 for every dollar transferred to producers; the figures for the European Community and the US are $1.50 and $1.38 respectively. It notes also that the Common Agricultural Policy "has probably been responsible for a loss of employment of around one million jobs in the non-agricultural sector of the EC." Yet despite such waste there is still no agreement on how to reduce trade and domestic distortions.

There are various other areas in which similar -- albeit it less costly -- distortions exist. Many, however, are more difficult to quantify in traditional trade terms. Barriers to advanced US technology, to transmission of data, and to foreign operations of banks and insurance companies all pose problems for US companies. Violations of copyright, patent and trade mark laws deprive US corporations of the fruits of their research and investment. And subsidies imbedded in economies cause competitive problems for American companies which must compete with them.

RELATIONSHIP BETWEEN LDC DEBT AND TRADE

While much of the focus of the trade discussion has been on trade imbalances with Japan, Europe and Canada, little attention has been devoted to the connection between Third World debt and the US trade deficit. In 1981, the US had a trade deficit with all developing nations of $33 billion; in 1985 it was roughly $51 billion. With Latin America the US had a trade surplus in 1981 of one billion dollars; in 1985 the US had a trade deficit of $18 billion. Although that figure represents only about 15% of the US trade deficit, it is nonetheless part of the problem. It is a particularly important problem for those areas of the US South East and South West that have traditionally relied on sales to Latin America.

There is a fundamental dilemma in US debt policy as it relates to trade. The advice we give to third world nations is that they should devalue their currencies, tighten up on domestic demand, improve the efficiency of domestic industries to boost their competitiveness, and thus earn more foreign exchange with which to service and repay their debt. Yet it is precisely the growing exports of Third World products -- particularly labor-intensive products -- that troubles American workers and companies that must compete. A second element of the problem is that although US banks hold only about one third of the Latin American debt -- with the banks of Europe and Japan holding the rest -- the lion's share of the increase in the exports of Latin America (which are necessary to service that debt) go to the US.

Higher growth in Latin America and a reduction in debt-related constraints on imports, would be of considerable benefit to the US. It will be some time before US exports to that continent reach their 1981 level of $42 billion -- a figure supported at the time by what proved to be excessive borrowing. But there is room for some increase above the 1985 levels of $31 billion. How this should be done without weakening the US banking system and its willingness to provide new funds to the indebted countries presents one of the important policy issues this country has not yet resolved.

And that leads to an even more troublesome dilemma. There are two major international imbalances that must be resolved simultaneously -- the US trade deficit and the Third World debt.If the US trade deficit is narrowed as the result of a decline in US growth rather than an increase in growth in other major industrialized countries that would lead to a deterioration in the Latin American debt situation. And if the US is consistently called upon to absorb the bulk of the increase in exports of the high debt countries as well as the more active competitors of East Asia that will simply add to a trade imbalance which is bound to generate an adverse reaction here, to the detriment of the high debt and other countries.

THE FUTURE

Reducing the US trade deficit will depend primarily on two factors:

-- the increase in prices of imported goods in this country along with a decline in prices of American goods abroad translated into foreign currencies -- followed by a shift in the pattern of new orders resulting these price changes. Although such shifts have occurred slowly, they are underway. For example, in a recent speech Japan's Prime Minister pointed out that his nation's exports in 1986 were down 1.2% while its imports were up by 12.5%. The most promising prospect for the US is for a growth in exports because that is where most price adjustment has occurred. This export improvement should be realized not only with our major industrialized partners but also with smaller countries where the lower dollar should give US exporters a boost. On the basis of price shifts that have already taken place, the US trade deficit is likely to decline by $25 to $30 billion in 1987 -- still leaving a sizeable trade deficit. But the longer this price and order shift takes to occur in amounts sufficient to make a real difference on trade, the sharper the future decline in the dollar is likely to be;

-- higher growth in domestic demand abroad relative to that in the US. From 1981 through 1985 exports accounted for nearly half of West German growth and over one quarter of Japanese growth while a third of US domestic demand has been satisfied by imports. Increases in domestic demand in our major trading partners -- not only in these countries but also in others with low inflation rates and high unemployment -- coupled with the currency and price changes described above would help to reduce the US trade imbalance. But we must recognize that together Japan and Germany account for only one-fifth of US trade so that their growth will not in itself be a panacea for US trade; moreover the extra 1 or 2% GNP growth in domestic demand that we might like in those nations will be diffused among many of their trading partners (which will diminish the direct benefits for the US, although it could have indirect ones. In addition, there are genuine differences of opinion over precisely how to boost growth in these countries and scepticism abroad about the benefits of "quick fix" stimulus. But the bottom line is that if stronger domestic demand abroad do not occur, the burden of trade adjustment will be placed even more heavily on exchange rate changes.

But there are other steps that could help. Although foreign assistance has rarely been thought of as a device for promoting trade adjustment, it has an important role to play. After World War II US financial assistance to Europe and developing countries helped to reduce world financial imbalances. Today the large capital exporting countries -- such as Japan, West Germany, the Netherlands, and Taiwan -- could utilize their export credit agencies to give their financial institutions guarantees and other incentives to provide untied, low interest loans to high debt countries pursuing sound domestic policies. That would enable the high debt countries increase growth and to loosen somewhat the debt constraints on their imports. The US would benefit from the resulting expansion of export opportunities in this hemisphere; and pressures on Europe and Japan for a "quick fix" stimulus would be reduced. Such financial support should not be seen as a way of taking high debt countries off the hook in their efforts to improve their domestic policies and performance but as an added inducement to put their economic houses in better order.

Let me now turn to domestic policy measures to improve our competitive position.

First, we must reduce the size of our domestic savings-investemnt gap. In the next few years that reduction can only come from reducing the financing required by the federal government. If the federal deficit can be cut in half by 1990 there should be room to finance a reasonable level of private investment and the remaining budget deficit to a substantial degree from our domestic savings, thereby substantially reducing our call on foreign capital with the trade and external implications attendant thereon.

Second, we must improve lagging productivity. There have been many suggestions for new types of industrial policy to address this problem. But here I find myself in the Vince Lombardi school of economics: let's concentrate on the fundamentals. Education, research and development and capital availability.

In 1958, in response to Sputnik, Congress passed the National Defense Education Act. That was instrumental in this country's surpassing the Soviets in space technology and other areas of technology for that matter. Imports are the Sputnik of the 1980s. Today we need a new act -- a National Productivity Education Act -- to emphasise the training of scientists and engineers; in addition it must substantially enhance programs for mid-career training and retraining to keep pace with rapid shifts in technology and jobs. Education today is a national security issue just as surely as weapons programs; parsimony on America's education budget is the greatest of threats to our continuation as a great military and economic power.

Congress will also need to revisit the issue of whether the US government is doing enough to support research and development. I must confess to a sense of uncertainty as to the net affect of last year's tax bill on the pace of US research. It will be important to monitor developments in this area in order to determine whether new tax inducements are needed.

Capital availability will largely be a function of the amount of public savings claimed by the federal government. To the extent that the deficit is reduced, more funds will available for the private sector; but the tax and regulatory climate will also be important in order to ensure that the terms on which capital is available are competitive with conditions in other nations.

This brings me finally to the question of US trade policy. This Congress has an extraordinary opportunity to shape a trade bill that addresses key American priorities. A trade bill is a leadership vehicle. It can have two basic functions:

--It can help forge a national concensus on trade policy. We need a national debate over trade leading to agreement on our basic goals. At present trade policy is carried out ad hoc with little agreement -- even within the executive branch -- on our overall objectives for improving access to other markets and modernizing the trading system, what our highest priorities are, or what we must give in order to achieve our goals. A bipartisan consensus -- shaped by an extensive dialogue with the private sector -- could give our trade policy consistency and direction.

--It can demonstrate to America's trading partners a new found unity of purpose between the executive branch and the Congress. That should strengthen the hand of our trade negotiators. And it should reduce concerns abroad -- often used as a pretext by those not eager to negotiate with the US -- that US negotiators do not speak for the Congress and that as a consequence Congress might refuse to implement the results of the negotiations.

It would be useful to consider few points when shaping this bill:

--trade negotiations, no matter how successful, will not in themselves dramatically reduce the US trade deficit; and US negotiators should not be expected to obtain concessions significantly greater than those they are empowered to give;

--strict reciprocity is unlikely to be possible. And confining the executive to that type of negotiating straight jacket would be undesirable. The concept of greater equivalence of opportunity is a sound one. We may not be able to obtain a completely level playing field, but we should insist on removal of the moats and fortifications;

--a distinction should be made between tightening up procedures regarding the use of Section 301 and changing US laws with respect to dumping and countervailing duties in ways that are inconsistent with the GATT; on the eve of negotiations to improve the multilateral trading system if the US were to unilaterally seek to reinterpret existing rules it would raise doubts abroad as to this country's willingness to play by any new rules that were negotiated and could be used as a pretext to stall negotiations.

-- it will be important to reinvigorate our commitment to US-Canadian trade negotiations. Not only can these provide new trade opportunities and remove distortions in cross border trade and investment; they also serve notice on other countries that the US is seriously interested in expanding trade and that unreasonable obstacles to multilateral progress will channel US energies toward areas in which bilateral progress can be made;

-- some accommodation between industrialized and developing nations must come out of trade negotiations; the developing nations of East Asia are among the world's fastest growing markets and most active competitors. Failure to agree on an appropriate balance of benifits and responsibilities with them would condemn the trading system to frequent disputes and disruptions.

-- the emphasis of our efforts should be on the expansion of exports rather than limiting imports; a more active application of pressures to open foreign markets should be recognized by the executive branch and America's trading partners as the necessary counterpart to averting pressures here for new import restrictions.

Mr. Chairman, exchange rate and trade issues are placing growing stress on the international economy and on this nation. This is a time for leadership. This country faces serious challenges in the period ahead. It can face these successfully if it recognizes the new era in which we live -- one in which we must compete more actively, conduct our domestic economic policies more wisely, and insist on an international economic system which affords this country the expanding opportunities that others expect of us.

Senator **Sarbanes**. Mr. Jasinowski, please proceed.

STATEMENT OF JERRY JASINOWSKI, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. **Jasinowski**. Thank you, Mr. Chairman.

I, too, have a prepared statement which I would like to submit for the record but would like to summarize my comments briefly.

Keying off of what the other two witnesses have said, Mr. Chairman, I think that they are quite correct in saying that we ought not to look at the quarter-to-quarter fluctuations in the economy as the major focus for public policy this year.

The real challenge before us is to look longer term at how to improve our international competitiveness in a manner that maintains our economic growth and standard of living. I think it will be a challenge to do that.

Saying a word about the President's Economic Report, I too think it's a good report in terms of its highlighting the macroeconomic part of this problem and I want to particularly make reference to the President's State of the Union Message and his statement that the Nation should focus as a top priority on international competitiveness. He said at one point, "We will achieve this first by guaranteeing that government does everything possible to promote America's ability to compete."

Having watched the administration over the last several years neglect the problems of international competition, it is certainly satisfying for us in the manufacturing sector to see this kind of emphasis as well as the attention that Secretary Baker has been giving to the exchange rate recently.

I would like to now summarize six major points, Mr. Chairman, which are as follows:

First, I think that the trade problem is going to be extremely difficult to bring down quickly and, if anything, I would say most forecasters are overly optimistic. The exchange rate improvement that has occurred has been primarily with respect to Japan and Germany and other European currencies. Half the exchange rate problem hasn't been dealt with yet.

We have slow growth abroad with insufficient demand for exports of the United States. Foreign competitors are looking at this competitive situation differently than we are. They are going for market share and American corporations are still forced to look at earnings because of the short-term focus of Wall Street.

So I think we are going to be fortunate to get the kind of improvement in the trade numbers that Bob Hormats has suggested and certainly not any more than that.

Second, this matter of trade competitiveness needs to be, as the Economic Report states and the previous two witnesses have suggested, in its proper context. It is largely a macroeconomic problem. I would say over 50 percent of the current trade deficit is caused by macroeconomic imbalances stemming in large part from the large Federal budget deficits. The impact that has on real interest rates, on exchange rates, and in turn on the cost of capital in this country—all of those together, as well as the differential in growth between the United States and other countries, are really the thing that has driven the trade deficit up to the crisis proportions that it is today. This has been a really spectacular jump from what it was in 1983, and you cannot find anything that's going on in American management and labor that can explain that kind of dramatic increase.

So as I said in my prepared statement, the whole question of the Federal budget deficit is the top priority for dealing with the trade crisis and in that regard it seems to me, among other things, that it is time for Congress and the White House to work closely. I think that as the Congress finalizes its alternative on the budget, it's important for both sides to sit down, at some sort of economic summit. I think the business community as well as the Nation continues to be frustrated that we have not made more progress on this important objective.

With respect to exchange rates, the other part of the macro problem and my third point, I would just indicate that there's been so much attention on what Secretary Baker has been doing with respect to Japan and Germany and Europe as a whole that we forget that half of the exchange rate problem has not been addressed with respect to countries like South Korea, Canada, some parts of Latin America, Taiwan, and that these countries represent a very substantial part of the American trade deficit and I know the administration is working on that set of issues quietly, and much of it has to be done quietly, but I think the Congress needs to get into that issue and to push for improvements in that area.

With respect to trade, I think the balance of what I've said, Mr. Chairman, is that trade policy—as the other two have suggested—is not the primary way in which one deals with the trade deficit. It is through exchange rates, the budget deficit, and macro policies.

Having said that, as we identify in the prepared statement, there is a whole host of major trade policy issues that need to be addressed having to do with expanding exports, reducing export controls, toughening up our import laws in a wide variety of ways, proceeding with GATT, proceeding with the Canadian trade talks. It's a mistake to conclude that because the trade deficit is primarily a macro problem that the trade policy changes that are required are not of great significance. The trade policy comment is really my fourth point.

My fifth point is to simply say that I think with respect to investments and capital spending that over the last 2 or 3 years we have seen substantial improvement. Some of that explains the recent improvements in manufacturing productivity. As the testimony outlines, we really put ourselves back in a good position. The new tax changes will reverse much of that progress.

Although there are some advantages to the recent tax legislation, however, I think it is very damaging to capital formation and we see a decline in plant spending and investment spending this year of about 4 percent and I think you can look for a general erosion of that part of the economic picture.

Finally, having said that it's 60 percent a macro problem and that beyond that there are a number of longer term public policy measures from trade to encouraging technology, improving our education system, not increasing government regulations—in a recent survey of our board, it's interesting that the board of directors of the NAM concluded that at least 25 percent of the improvements necessary to be fully competitive on a world basis must come from within the corporate sector. It is a serious mistake to believe that this is only a public policy issue. A lot of progress has been made in terms of cost reduction and quality improvements, but substantial additional work in the private sector needs to be done and we identify some of those in the prepared statements, Mr. Chairman, and I think it's important to look at this effort to become internationally competitive as a joint public and private cooperative effort because the competitive challenge we face with respect to these newly developing countries and others is much larger I think than is generally recognized.

Mr. Chairman, those are the six points. I would simply conclude with one brief comment on the short-term economic outlook. There's a certain amount of optimism circulating based on economic activity in the fourth quarter and the stock market, which I think is misleading.

A lot of that is tax-related activity and you're going to see a substantial slowing in the economy in the first and second quarter of 1987 as that evaporates and we find that the trade deficit is far more stubborn in terms of its decline and that the consumer and investment picture is weak. I think we will avoid a recession. I think it's a slow growth picture until the second half of the year, however, when tax reform begins to provide some stimulus to the economy.

Thank you very much, Mr. Chairman.

Senator SARBANES. Thank you, Mr. Jasinowski.

[The prepared statement of Mr. Jasinowski follows:]

PREPARED STATEMENT OF JERRY JASINOWSKI

I am Jerry Jasinowski, Executive Vice President and Chief Economist of the National Association of Manufacturers. NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Our members range in size form the very large to over 9,000 small manufacturing firms. NAM member companies employ 85% of all workers in manufacturing and produce over 80% of the nation's manufactured goods. On behalf or our members, I am pleased to be here today to express the Association's views on the general economic situation, fiscal policy, capital investment and international trade.

I. INTRODUCTION

This statement reviews the economic outlook, examines three major policy areas relating to the current economic environment, and summarizes NAM's top economic and policy priorities for 1987. Section II begins with a brief overview of the current economic situation. Section III deals with fiscal policy and demand management, with particular reference to the Administration's FY 1988 budget. Section IV examines recent trends in capital formation, focusing on the implications of tax reform. Section V examines the trade deficit and its causes. Section VI summarizes NAM's 12-point policy program.

II. THE CURRENT ECONOMIC SITUATION

The recent statistics create an ambiguous picture of the near-term outlook for the economy. The rise in the leading indicators has been due primarily to the surge in activity in December, and is more indicative of recent rather than future economic conditions. Much of the improvement in employment is also spurious, resulting from errors in measurement and inaccurate seasonal adjustment procedures. However, a recent rise in new orders and the advance of the stock market are causes for greater optimism, suggesting that the economy may possess enough momentum to avoid a recession this year. A recent fall in auto sales is more disturbing, indicating that the rise in new orders may lead to nothing more than an involuntary accumulation of inventories.

Sorting through these conflicting statistics, we continue to believe that 1987 will be a year of weak economic activity. There are several reasons why our prognosis is somewhat more pessimistic than the consensus. First, the new tax laws incorporate a business tax increase of approximately $15 billion over six months, due to the deferral of the effective date of the corporate rate reduction. Simultaneously, increases in the user cost of capital implied by tax reform should further contract investment spending.

Secondly, consumer spending is likely to be weak in 1987. At the current time, consumer debt is unusually high--mortgage and consumer installment debt now stand at a combined total of 75% of disposable income--while the individual savings rate has been drawn down to less than 3%. Under the circumstances, there is little room for major increments in consumer spending. Notwithstanding the increase in disposable income implied by lower marginal tax rates, the cost of debt amortization will be raised by the diminished implicit subsidy for borrowing in the new tax laws, with the result that the lower tax rate will be partially negated by higher after-tax interest costs. On this basis, NAM projects only a 2% improvement in consumer spending in 1987.

There will be some improvement in the trade deficit in 1987, due to the continued devaluation of the dollar and slower growth in domestic demand for imports. In this respect, the dollar has already fallen more sharply in the last two months than generally assumed by most forecasters, and in some instances more than predicted for the entire year. The result is that the outlook for trade is substantially better than generally assumed, although one mitigating factor here is that the persistent unwillingness of the other industrial countries to reflate means that there will be minimal growth in demand for American exports. Another mitigating factor is that the improvement in the exchange rate has been very uneven, with the bulk of the improvement coming against the German mark and the Japanese yen; by comparison, the dollar has not declined against the currencies of Canada, Latin American and the Pacific Basin. Taking these factors into account, net exports should improve in 1987 by magnitudes of up to $25 to $30 billion.

While this prognosis is relatively optimistic, the improvement in trade will not in and of itself be sufficient to boost the growth rate of the economy. The chief problem here is that since the Federal Reserve will endeavor to prevent to dollar from falling too rapidly, monetary policy will be somewhat less accommodative than earlier forecast. Making relatively pessimistic assumptions about domestic growth, the projected GNP increase for the year comes to only 1.7%. However, with more optimistic investment and consumer spending assumptions, the growth rate could be in the range of 2.5%, roughly comparable to 1985. But even the more optimistic scenario has adverse implications for deficit reduction (see below), since revenues will be lower than anticipated.

III. FISCAL POLICY AND DEMAND MANAGEMENT

The most serious difficulty with the Administraton's proposed FY 1988 budget is that it relies on unrealistic economic assumptions in order to meet its deficit reduction targets. In order for the projected deficit, i.e., the Gramm-Rudman target of $108 billion to be realized, the economy would have to expand by 3.1% in 1987, and 3.5% in 1988. For reasons indicated in Section II, this is unlikely. With our forecast of 1.7% growth in 1987, however, the annual deficit for this calendar year would come to $176 billion, even assuming that all the revenues from the "stagger" provision in tax reform are earmarked for FY 1987. Thereafter, even in the event that the economy were to attain a 3% growth rate the following year, the deficit would rise to $193 billion or 4.2% of GNP in calendar year 1988, due in part to the additional personal income tax reduction contained in tax reform. The result is that substantially greater reductions in spending will be necessary in order to reduce the deficit to targeted levels.

Beyond these estimates, a recession in 1987 or 1988 could substantially raise the deficit. The extent to which a downturn in the cycle is a threat to fiscal stability can be illustrated through long-term projections for the economy and the deficit. For instance, in the event that the economy were to achieve three years of continuous growth in 1988-90 at 3.3% per year, the deficit would decline from $193.7 billion in calendar year 1988 to $130.1 billion, or 2.4% of GNP by the end of the decade. However, in the event that the growth rate were to be a point lower per year, the deficit would be approximately $30 to $40 billion higher in 1990. A major recession during this period, eg. a downturn along the lines of the 1974-75 or 1981-82 recessions, could raise the deficit by over $60 billion in one year alone.

It is likely that the economy will continue to experience large structural deficits well into the next decade. The prediction of contemporary theory for the effect of bond-financed deficits on the economy is for an asymmetric impact: in the short-term, the deficit raises real economic activity due to increasing purchases, but over a longer-term the deficit is contractionary due to the "crowding out" of the private sector, higher real interest rates and the trade deficit resulting from appreciation of the exchange rate.

The prognosis of an asymmetric impact is fully supported by the experience of the 1983-86 recovery. The recovery consisted of a five-quarter boom in 1983:2 through 1984:2, followed by a period of sluggish growth thereafter, which has continued to the present. This slowdown in economic activity has been particularly serious in manufacturing. The major reason for this has to do with the fact that goods-producing sectors are considerably more vulnerable to high interest rates, import penetration, and the effects of the overvalued exchange rate.

The causes of this asymmetry in the business cycle have to do primarily with the rise in interest rates in the United States, and with the concomitant appreciation of the dollar. The effects of the deficit on interest rates have been demonstrated econometrically in several recent studies. For instance, two recent NBER monographs by Martin Feldstein suggest that some two-thirds of the increase in real interest rates in 1982-85 was caused by the increase in the long-term structural deficit. In turn, when expectational mechanisms are taken into account the rise in the structural deficit was responsible for as much as 67% of the appreciation of the dollar in 1982-85.

IV. CAPITAL FORMATION

The growth rate of capital investment in the United States over the last few years has actually been relatively favorable. During the recovery of 1983-85, business investment spending was unusually strong, with capital formation surpassing its growth rate of all prior postwar recoveries. There are, of course, compelling reasons why this should be the case. The combination of the ACRS depreciation system and the ITC gave the United States one of the most advantageous capital cost recovery systems of all the industrial countries.

The speed of the recovery in capital spending meant that during the early 1980s, the United States was well on the way to redressing one of its longer-term structural problems, the fact that capital formation in this country has generally been lower in relation to aggregate output than in the other major industrial nations. Although this relationship has held true for the entire postwar era, it has ameliorated recently.

For instance, in 1970 the ration of gross fixed capital formation to GNP stood at 17.4% in the United States, compared to 21.0% in Canada, 23.2% in France and Italy, and 25.5% in West Germany. However, in 1984, the most recent year for which comparable figures are available, the investment share surpassed 18% in the United States, while in the other industrial countries it had fallen appreciably to 19.9% in Canada, 18.5% in Italy, 19.8% in France and 20.8% in Germany. In sum, as of 1984, the United States had nearly eliminated the differential in investment ratios. Parenthetically, this finding corroborates the results of numerous econometric studies which demonstrated a large and statistically significant impact for ACRS and the ITC on capital spending.

However, there is considerable evidence that the recent reform of the tax system has effectively halted this investment improvement. Tax reform incorporates several provisions which raise the user cost of capital and are likely to reduce capital spending: the retroactive deletion of the investment tax credit (ITC) to 1986, the effective rescission of accelerated depreciation (ACRS) through the lengthening of some capital asset lives and the imposition of the new corporate minimum tax, provisions against which the transition from 150% to 200% declining balance methods for equipment militates very little.

A related provision in the new tax laws which has not been accorded sufficient attention is the changes in the accounting rules, under which all manufacturers would be obliged to capitalize indirect production costs. In essence, under the previous tax code, using the short-term method of accounting, indirect production costs could be fully expensed the year in which they were incurred, whereas under he new laws they must be capitalized and depreciated over a period of several years. The deletion of the ITC and the modifications of ACRS together raise the user cost of capital by magnitudes of 18% to 20%. The change in the accounting provisions may raise the user cost of capital by as much as an additional 3.5%.

Econometric simulations indicated that holding all else constant, tax reform will lower business fixed investment by as much as -17% relative to current law over a six-year period. However, the near-term effects will be compounded by the slowdown in the economy and by widespread underutilization of capacity (currently somewhat less than 80%). The result is that nonresidential fixed investment is projected to decline by -4% over 1987, with the largest declines coming in equipment.

In addition to the losses in domestic output, the less favorable treatment of capital spending in the United states should also undermine its competitive position. The ratio of capital spending to GNP will now shift adversely. Moreover, as other countries are able to improve their capital spending more than the United States, their productivity should also increase more rapidly, placing them in a more favorable position vis-a-vis relative prooduction costs:

V. THE TRADE DEFICIT AND INTERNATIONAL COMPETITIVENESS

There has been an increasing concern recently over the problem of international competitiveness, motivated in part by the emergence of an unprecedented trade deficit. The magnitude of the international trade problem is revealed in the fact that in 1986, the merchandise deficit stood at $175 billion, nearly 4 percent of GNP, and more than five times as large as in 1980.

From a macroeconomic policy standpoint, there are two major causes for the deterioration in competitiveness; 1) the overvaluation of the dollar exchange rate, particularly since the massive appreciation of 1980-85; 2) differentials in the growth rate of demand for traded goods in the United States and overseas. The magnitude of these factors has shifted over time, but on average they explain the overwhelming bulk of the variance of exports and imports, with the remainder being accounted for by special factors such as the OPEC crises and structural problems.

The Exchange Rate Between late 1980 and early 1985, the dollar exchange rate appreciated by roughly 70% using the Federal Reserve's G-10 index, leaving the dollar overvalued by as much as 50% relative to purchasing power parity. Given the close historical relationship between the exchange rate and exports, it is somewhat surprising that the trade deficit has not improved since early 1985, inasmuch as the dollar has fallen by about -30% as measured by the G-10 index. However, the substantial fall in the dollar as measured by the commonly used Federal Reserve 10-country index is to some extent illusory with regard to its impact on trade, inasmuch a the G-10 excludes the currencies of trading partners in the Far East except Japan, and all of Latin

America. It also weighs each nation's currency according to national shares of world manufactures trade. One effect of this is to understate substantially the impact of the depreciation of the Canadian dollar in the 1980s.

One alternative measure is the Morgan Guaranty 44-country index of the exchange rate, with weights based on other countries' share of American trade. Compared to the steep fall in the Fed G-10 index over the past year, this 44-country bilaterally-weighted index shows a more moderate decline. The dollar had fallen by -19% since its peak of March 1985 by the end of 1986, the most recent date for which the revised Morgan Guaranty index is available. However, in nominal terms, this was still 51% over 1981 level, while in real terms it was 7% over its 1981 level. By comparison, the Federal Reserve G-10 index had fallen -39% relative to its March 1985 peak by the end of January 1987.

In this respect, the Treasury's policy of coordinated intervention in foreign exchange markets, which has been strongly supported by NAM, has thus addressed the issued of exchange rate misalignment regarding the largest industrial countries, but not Canada, the Far East NICs and other developing countries which account for a large part of the total trade deficit.

High Growth Here and Slow Growth Abroad The relative levels of American and foreign domestic demand growth have historically had a significant impact on trade. Relative demand levels have shifted somewhat, but when foreign export-led growth is discounted, it becomes apparent that domestic demand ran much stronger here than abroad, particularly during the earlier stages of this business cycle. The result was a massive surge in demand for imports in the United States, at a time when demand for American exports overseas was extremely weak. Since the start of the recovery, consumer spending has grown more rapidly than the average of postwar business cycles, while GNP and industrial production have both grown more slowly than average.

While it is therefore evident that the strength of domestic demand has contributed to the import surge, the mirror image of this problem is that weak demand overseas has inhibited exports. Despite improved rates of GNP growth in the EEC and higher effective domestic demand in Japan, these countries are still well short of the domestic consumption rate. Japan's effective domestic demand grew at 3.5% in the twelve months through the first quarter of 1986, and the total EEC rate was under 3% (the German rate was still only 1.6%).

High Consumption and Low Domestic Savings While the combination of excessively rapid growth in demand here coupled with excessively slow growth abroad has clearly been reponsible for the recent deterioration in the trade deficit, there is a more insidious problem: the marginal propensity to import in this country is exceedingly high, much higher than in other countries. One possible explanation for the extraordinarily high propensity to import is that the propensity to consume out of disposable income is also atypically high in the United States. One way to measure the propensity to consume is through its inverse—the savings rate. Historically, the rate of personal savings in the United States is unambiguously the lowest of all the industrial nations, even after adjusting for differences in measurement. Moreover, as of late 1986, the savings rate fell to an unprecedentedly low 2.8 percent of disposable income.

The low savings rate provides one further explanation for the overvaluation of the dollar. Because domestic savings have been so low, they have been inadequate to meet the borrowing requirements of the Federal government, business and consumers. The result is that in order for public and private sector loan demand to be satisfied, capital has had to be imported. As noted above, much of this was in the form of foreign purchases of Treasury securities, which raised the pool of loanable funds and prevented the fiscal deficit from engendering an intractable "crowding out" situation in capital markets. However, the cost has been to make the United States a net external debtor for the first time since World War I.

Structural Factors The preceding analysis has focused on the proximate macroeconomic causes of trade flows. It may also be of interest to briefly look at structural factors which contribute to the economy's potential ability to compete. One measure of efficiency is the rate of productivity growth.

During the 1970s, productivity growth underwent a sharp slowdown. A close inspection of the data reveals that this slowdown took place during relatively discrete periods: 1974, 1979-80, and 1982, i.e., periods of sluggish productivity coincided for the most part with periods of slow economic growth. Econometric studies have isolated the major causes of the productivity decline as being the successive increases in energy prices and the resulting recessions. During the most recent business cycle, the recovery in aggregate productivity was disappointing, although this subnormal performance was due primarily to higher service employment.

On the other hand, manufacturing productivity improved substantially, rising by over 5% in 1983 and over 4% in 1984-85. The average growth rate of 3.1% in 1979-85 was above the postwar trend of 2.7% in 1955-73. The gains recorded in 1983-85 were among the fastest on record, and well above increases in Canada and most of Europe, although still behind the gains recorded in Germany and Japan. However, the preliminary data for 1986 indicate a slowdown in manufacturing productivity growth, due to the simultaneous fall in capital formation and the slower rate of job reduction in industrial sectors. Hence there is every reason to expect that the favorable manufacturing productivity performance of 1983-85 is slowing.

Thus, it is doubtful whether the increases witnessed in 1983-85 can be sustained, given the implications of tax reform for investment in manufacturing sectors. In this respect, the decline in productivity projected for 1987 is likely to cause some further exacerbation of the trade deficit by raising unit costs at a time in which the inflation rate will be increasing for other reasons. The aggregate productivity growth rate is currently forecast to be negative in 1987, while manufacturing productivity should grow more slowly, largely as a result of diminished capital formation.

Conclusions. On balance, the overall mix of factors affecting the competitiveness of the United States is negative. Thus, while the trade deficit may ameliorate somewhat in 1987, this country will face a problem of chronic trade imbalance for years to come. As to the breakdown of the major causes, the exchange rate and excessive consumption of imports in the United States have been the primary factors responsible for the deterioration in the trade accounts, and for reasons detailed below, they will probably be the most difficult to address. In the structural areas, the United States has actually made some improvements in the last few years, witnessing significant increases in capital formation, and productivity. However, it is not likely that these developments will continue, and the recent "reform" of the tax code could well result in more adverse structural developments.

VI. POLICY RECOMMENDATIONS

Based on a recent survey of the Board of Directors, and taking into account the analysis summarized in this statement, NAM has developed a 12-point policy program for 1987. This program places particular emphasis on the ability of the United States to successfully compete in world markets.

1. The country is at a crisis point in its trade competitiveness. There should be a national commitment to trade competitiveness, which should be made the country's leading economic priority for both public policy and the private sector.

2. As part of this national commitment, there should be an increased recognition of the key importance of manufacturing to economic health. In this respect, growth in industrial production has historically driven growth in GNP by creating demand for services, while manufacturing productivity gains are typically about three times as great as for the aggregate economy, and industry represents the primary source of technological innovation. Further, since about 75% of the trade deficit has been in the manufacturing sector, higher growth rates in industrial production will be necessary to eliminate the trade deficit without domestic output losses.

3. The fiscal deficit should be reduced. The structural deficits that are projected to persist for the remainder of the decade are not commensurate with macroeconomic stability; further, their impact will be particularly deleterious to manufacturing industries that are sensitive to high interest rates and vulnerable to import penetration. What is needed is a systematic plan to bring the deficit down to levels that will insure lower interest rates, a more realistic exchange rate and a stable business cycle. The avoidance of tax increases and concentration on spending reductions as a means of achieving fiscal restraint constitute the central components of this strategy. The adoption of fiscal targets commensurate with these objectives, for instance by bringing the budget into surplus at full employment, could go a long way toward setting the stage for future industrial prosperity. An economic and budget summit meeting between the White House and Congressional leaders — for the purpose of fundamentally coming to grips with the

structural budget deficit problem — should be actively pursued by both sides.

4. The exchange rate should be lowered to levels commensurate with purchasing power parity, through bilateral negotiations with countries where there has been no exchange rate improvement, such as South Korea, Taiwan, Brazil and Canada. Congress should work with the Administration to develop options for longer-term exchange rate reform.

5. Trade policies should be strengthened in order to stimulate exports. Major policy priorities include: a) Press the other GATT countries for meaningful improvements in the GATT in forthcoming multilateral trade negotiations. b) A free-trade agreement with Canada that advances the interests of American industry. c) Establish a joint business-government market development program targeted on Japan, and modeled on the highly successful Market Development Cooperation Program established by the Agriculture Dept. in the 1950s. d) Insist that foreign governments remove their unfair trade barriers and discontinue unfair practices. e) Cut back the export control list and otherwise lessen the burden of export controls. f) Offer American corporations the financial support they need to compete with foreign manufacturers that benefit from effective government financing programs. g) Undertake new efforts to open foreign telecommunications markets to American products. h) Reform the Foreign Corrupt Practices Act. i) Amend the Tariff Act to protect intellectual property rights in the United States. j) Improve the escape clause of the Tariff Act. k) Review antidumping law, and l) Tighten law against imports that threaten national security.

6. At the private sector level, improvements in corporate ability to compete is essential. In this respect, the NAM Board of Directors recently agreed that at least one-fourth of the improvement in international competitiveness will have to come from improvements in cporate practices.

These include cost reductions through restructuring, quality improvement, more aggressive foreign marketing, the accordance of a higher priority to improvements in manufacturing processes, encouraging greater employee commitment to competitiveness, and greater application of research to the production process.

7. There should be further regulatory reform in order to reduce governmentally-mandated costs on the private sector. Regulatory reform should include new product liability standards, greater deregulation of transportation, reform of antitrust, avoidance of shifting the cost of government programs to the private sector, and general reductions in regulatory burdens.

8. Policies should be instituted to raise investment and savings. In this respect, with tax reform already in place, there is little that can be done to alleviate the short-term contraction in investment that will result from its provisions. Nevertheless, at some future time, there may be greater opportunities for raising capital formation through the tax code. These would include a) consideration of an investment tax credit for equipment used in manufacturing; b) exemption of depreciation from the alternative minimum tax; c) modification of accounting provisions regarding capitalization of depreciable assets; d) provisions to encourage greater individual savings, including restoration of IRA deductibility; e) in the long-run, a shift in the basis of taxation from income to consumption should be considered. This would have the effect of raising the investment share of GNP and lowering the consumption share.

9. Greater support should be given to technological innovation, through extension of the R&D tax credit, increased civilian R&D spending, and increased protection of intellectual property.

10. Create a more stable financial environment by regulating hostile takeovers, through requirements that the notification threshold for acquisition of a company be lowered, that the time period for offers be extended, and that the Williams Act not be circumvented by using the tender offer process to acquire shares. Further, the SEC should be given increased powers to pursue insider trading and other abuses.

11. Greater investment in education and retraining, particularly among displaced and low-skill workers.

12. The central criterion for major policy decisions should be their impact on trade competitiveness and growth. Major governmental actions should be subjected to a competitiveness impact statement. Further, as part of making competitiveness a national priority, existing government agencies should be consolidated into a single Department of International Trade and Industry.

Senator SARBANES. Mr. Sinai, please proceed.

STATEMENT OF ALLEN SINAI, CHIEF ECONOMIST, SHEARSON LEHMAN BROS., INC.

Mr. SINAI. Thank you, Mr. Chairman. I, too, have a prepared statement for the record and will selectively pick and choose from the prepared statement in my comments.

Our most recent estimates for the U.S. economy indicate that the most likely possibility for the next couple of years is sustained but slow growth—slow to modest growth, better balance in the components of economic growth, worse but not bad inflation, improving business profits, and a relatively stable picture for interest rates, although with some significant risks of upticks in the near term and probably a gentle upward turn in 1988.

A major risk to this outlook for the U.S. financial markets and possibly the economy is the much lower dollar so far this year and the inability of major trading partners to agree on coordinated action to stem the declines. The dollar problem for interest rates and hence for the economy is threefold. It's in part a consequence of the twin budget and trade deficit problem. To help correct a large trade deficit, one element is a lower dollar. A lower dollar reduces the net returns to the foreign investors who help fund the budget and trade deficits. Nominal interest rates then must rise to offset the actual or prospective losses because of currency depreciation. Foreign investors will always pick up a fair share of necessary financing. The issue is, at what price, at what interest rate?

Second, a lower dollar suggests increased future economic growth and possibly higher inflation somewhere down the road, especially if excessive Federal budget deficits are in prospect at the same time, and they are. Faster growth and higher inflation tend to raise interest rates.

Third, a lower dollar presents a problem to the Federal Reserve. Even if desired, any unilateral easing would tend to lower the dollar more. Given the expected effects of a lower dollar on growth and inflation, interest rates may not decline even when the Federal Reserve lowers short-term rates. With the usual effects from easing monetary policy not possible, the central bank can find itself "hamstrung."

The risks to the U.S. financial markets and the economy of the dollar problem and the interest rate-related aspect of it is, I think, clearly present now, where we've had a taste of dollar-related jitters and fears in the fixed income markets, fears of too strong growth and higher inflation through a modest upward spike of interest rates. The large trade deficits depress the dollar. The lower dollar causes expectations of higher inflation and more growth later on. Interest rates have to rise to attract sufficient funds, both domestic and foreign, to finance those deficits. The prospect of higher inflation from the stimulus of exessive Federal budget deficits and some turn in trade keep real interest rates too low to attract investors. The dollar remains under pressure and interest rates keep rising. You really have a self-cycling mechanism here that cumulates on itself and it is very risky.

The Federal Reserve is trapped in such a situation and cannot stop a rising trend for interest rates on its own in this kind of situation.

If interest rates were to rise sufficiently—by that, I mean 1 or 2 percentage points—growth would be threatened and perhaps aborted. The rise of interest rates so far is modest, a quarter to a half percentage point, although having occurred in just a week or two. Several short- and long-term interest rates are actually higher now than back in May 1986. Without policy actions to reduce the budget deficits as they now appear likely or to stop the decline of the dollar, there is significant upside risks on interest rates and downside risks for the economy.

So though the current jitters may pass, and our forecast assumes that they will, I do have to point that out as a risk. They do represent a possible fly in the ointment in what otherwise is a reasonably positive outlook for the next 2 years; 1989 and 1990 are another matter.

Let me quickly summarize the features of our view. Our numbers are in the statement forecast as of late January. One is that the economy will keep growing, although modestly, 2.5 to 3 percent in 1987, and less than is expected by the Council of Economic Advisers, but not that much less, and 3 percent plus in 1988.

Why? Well, we've had a lot of help the last couple of years—lower inflation, lower interest rates, the lower dollar, and strong stock markets here and abroad to keep economies going. The lower dollar is a help, ultimately for trade. It is, of course, a negative for Japan and Germany, but they don't buy that much from us and so, net, the lower dollar would be a help to growth, provided it does not lead to unnecessary rises in interest rates.

Second, the worst seems over for the beleaguered sectors of the economy—manufacturing, mining and perhaps even agriculture. That is not to say times are good in those sectors of the economy, but I think the worst is over. The most recent information on employment and production in manufacturing shows an upturn during the fourth quarter and in January. Mining production rose in December. Higher oil prices probably are going to end the decline in oil and gas.

Finally, the usual excesses and imbalances that normally precede a recession in the United States are not yet present. Growth has been too slow and has prevented them from arising. Indeed, there was a massive liquidation of inventories by business last year that has removed one of the worrisome excesses from the economy.

The economy can't grow too fast, though, for several reasons. One is that we are still making a rather major adjustment from being basically a goods economy to one that is essentially services, information and transactions based.

Second, the U.S. economy—and this is a bigger problem in terms of why we cannot grow rapidly—has a huge trade deficit; a problem of external balance. In order for the trade deficit to move lower, one adjustment other than a depreciating dollar is for the United States to grow more slowly than our trading partners. In such a case, fewer goods would be purchased from abroad and more exports purchased from the United States.

A problem for us is that our major trading partners are targeting lower growth rates than before. Japan has targeted a 3.5 percent growth rate. Previously, more than 4 percent was desired in that country. Moreover, Japan will not achieve 3.5 percent. In actuality, they may be fortunate to do 2.5 percent growth. Germany has targeted a 3 percent growth rate, although actually forecasting 2.5 percent. And, for Germany, growth at 2.5 percent may be difficult to attain. For the fourth quarter in Germany, there was no change in gross national product.

As long as the trading partners of the United States—the major ones—accept less growth than before, we, too, will have to accept slower growth than before. Otherwise, the trade deficit could worsen or not improve very much. And, if we don't deal with the trade deficit now, we will have to deal with it at some point. It's a question of when you accept that slower growth.

The third reason for modest growth, especially early this year, is the Tax Reform Act of 1986, which, on balance, is restrictive in 1987. Business taxes will be higher by about $25 billion this year. Consumers will get approximately a $15 billion tax cut. That's a net tax increase of $10 billion that should take away half a percentage point of growth, especially early in the year. Some of that will come back next year and later this year as consumers begin to spend more out of what are going to be very massive tax cuts for them.

A third feature of our expectations is that the economy is shifting gears to better balance. That is welcome to see. It's a longer run process that just has begun. It should go on for the next few years and by that I mean the areas of the economy that previously were weakest are now getting stronger. Those areas of the economy that previously drove the expansion and were strongest, are now weaker. Trade, real net exports and the industrial sector should do better. Consumer spending and housing, driving forces in the economy this past year, will show less strength.

The recent data show this emerging shift in the composition of spending. In the fourth quarter, consumer spending declined, housing weakened, and real net exports improved, with a good-sized upturn in exports across the board, at least in the inflation-adjusted GNP data that showed up in the third and the fourth quarters.

Orders, production, and employment have been rising for several months. Employment growth, in particular, has been most impressive, rising over 225,000 per month on the nonfarm payroll basis, for 5 consecutive months. Inventory-sales ratios in manufacturing are at or near the lows for the current expansion, and that indicates a need for inventory rebuilding.

For merchandise trade, we expect—and we are optimistic on this—a $35 billion to $40 billion improvement over the year 1987. The weaker dollar and soft export prices are helping exports. Weaker consumer and business spending in the first half should reduce the volume of imports. That improvement provides 0.7 percentage points of our expected 3 percent fourth-quarter-to-fourth-quarter growth rate, and it is helpful to a 3.5-percent increase in industrial production, the best improvement, if it should occur, since 1984.

Consumer spending will rise more slowly, down from the fast rates of 1985 and 1986, but coming back stronger this year and in 1988 because of large tax cuts.

A fourth feature in our expectations is that inflation will be worse, but not bad. That translates into figures of 3 to 3.5 percent, but accelerating over the year.

The prospects for inflation in the coming year and years after, though, now put us on the other side of the "U"—I was going to say "hill"—but we are really over the best news on inflation. The positives are still too many goods chasing too few dollars. There's no demand-pull inflation of consequences yet to be seen. Second, unit labor costs are rising slowly. Average wage compensation is increasing at about a 2 to 3 percent annual rate.

The negatives are threefold. One is higher oil prices, which will show up in some of the data for a few months. A major potential negative is the lower dollar. Higher imported goods costs will be passed on and accelerate inflation rates. The last negative for inflation is protectionism. A number of trade measures, tariffs, and quotas have been adopted or are in the works, and eventually will have inflationary effects.

This inflation picture, while probably a negative for U.S. fixed income markets, is a plus for equities. For a while, accelerating inflation can be a plus, pushing revenues and profits higher for many companies. Ultimately, high and accelerating inflation, if sustained, is negative, for both the bond and stock markets.

Interest rates, though there are risks, should be essentially stable and that actually, if it happened, would be a very nice pattern at this stage in the expansion. We have viewed interest rates as being in essentially a trading range now for quite some time, long-term rate fluctuating within plus or minus half a percentage point at most or 1 percentage point from current levels and short-term interest rates essentially fixed in a range around the 5.5 percent discount rate, which we do not expect to be changed by the Federal Reserve. Not unless there is some breakthrough in our negotiations with our trading partners and moves to stimulus that involve lower interest rates on their part is it now likely that the Federal Reserve would cut the discount rate any time in this first half.

Let me turn finally to what is a key issue and a key risk. It is the same issue that the Congress has been hearing about from economists now for many, many years and certainly Congress has done an excellent job in contributing to changing the previous expectations on Federal budget deficits which 3 years ago at this time was that deficits would soar, with no end in sight. Progress has been made on the deficits. Unfortunately, I think it's a situation much like where we are on competitiveness—we're more competitive, but we haven't done enough. On the budget deficits, we've done something but is isn't enough and it is now coming back to haunt us; this time through the mechanism of trade deficits, the dollar, and the dollar risk to interest rates and the dollar risk to inflation and the combination of eventually higher inflation, higher interest rates, and the end of this long business expansion.

The deficits are too high. Our estimates—and we think we're making reasonable estimates—under current conditions, reasonable expectations for the economy, congressional deliberations and administration reactions show a $190 billion unified budget deficit for fiscal 1987, $176 billion for fiscal year 1988, $164.5 billion in 1989, and $140 billion in 1990. These are far above government forecasts, far above the Gramm-Rudman-Hollings targets, and they already include assumptions that somehow Congress will cut $34 billion for fiscal year 1988 and up to $54 billion for fiscal year 1990. We're already granting some cuts which have not yet been approved or legislated.

As the U.S. economy begins to recover from the pronounced weakness of the past 2 years, it is absolutely necessary that the Federal budget deficits be reduced by more than what is in prospect. Structural budget deficits, the cyclically adjusted budget deficits, are too high as well, ranging from $165 billion to $170 billion in fiscal year 1988 to over $100 billion in fiscal year 1990. They have declined, but are too high for growth without the accelerating inflation, overextension, and higher interest rates that typically set the stage for a business cycle downturn.

A point of no return has been reached where it is now such a problem that one has to define a great balancing act—just cutting the deficits to meet the Gramm-Rudman-Hollings targets is no longer the way to do it. Because the deficits are worse than expected when the Gramm-Rudman-Hollings targets were set, the cuts now required to met the Gramm-Rudman-Hollings targets are much bigger than what had been envisioned and that means that kind of budget restraint would be very restrictive for the economy—too much so when the economy is just beginning to come out of the malaise of the last 2 years. But doing so little as now seems to be where we are headed is also a danger because of trade deficits, dollar, interest rate and inflation consequences.

So now, the task is somehow to find the right downglide path in the budget deficits that is neither too much nor too little and I must say that after observing the budget process and deliberations for the last 7 or 8 years, that is a tough challenge for Congress.

Whatever downward path for the budget deficits that is arrived at in the budget process somehow has to be offset by the appropriate Federal Reserve policy, and I must say it's hard to be optimistic that the Federal Reserve could time and fix its policy in such a way to offset whatever budget restraint is applied.

And now, there is a third leg in the triangle of policy difficulties, and that is the international side where the policies of our major trading partners—their macroeconomic policies—have become an important ingredient in our own domestic outlook. It isn't so simple as it was 3 or 3½ years ago when people like me told Congress that the deficits are too high and to do something about it. It's much more complicated and much more difficult now.

So for those reasons—and I, like others, have suggestions on how to do it, but it now takes a grand scheme and a rather ideal approach and I'm not sure that Washington can pull it off because Tokyo and Bonn are very much involved as well—the risks to the business cycle and the expansion are growing significantly. I would say, in conclusion, that by and large, the economy is emerging from its recent doldrums and is ready to enter a period of better, more balanced growth. Inflation is going to be worse, but not bad this year. Corporate profits will do better. If interest rates stay stable, we will keep expanding well into 1988.

But potential cracks in the expansion are beginning to appear. They are the outgrowth of still excessive Federal budget deficits, and now problems in trade and problems with the dollar. If Congress and the administration fail to get the budget house in order and the United States and its trading partners fail to move toward complementary macroeconomic policies, then the usual business cycle sequence of higher inflation, higher interest rates and financial troubles may well appear to bring an end to the current, long business expansion. The business cycle has not been repealed. We're in the fifth year, headed for the sixth year of expansion. It will take hard work and judicious planning to realize the goal of sustained, noninflationary growth to the end of the decade. Thank you.

[The prepared statement of Mr. Sinai follows:]

PREPARED STATEMENT OF ALLEN SINAI*

Prospects and Risks for the U.S. Economy and Financial Markets

The most recent Shearson Lehman forecast of the U.S. and world economies and financial markets (Tables 1 and assumptions, 2 and assumptions, and 3, most likely possibilities) indicates: 1) sustained but slow growth through 1987 and 1988; 2) better balance in the components of economic growth; 3) worse, but not bad inflation; 4) improving business profits, both in quantity and quality; and 5) relatively stable interest rates in 1987, although with risks of upticks over the near term and somewhat higher during 1988.

A major risk for the U.S. financial markets and possibly the economy is the much lower dollar so far this year and the inability of major trading partners to agree on coordinated actions to stem the declines. The dollar problem for interest rates is threefold and in part a consequence of the "twin deficits"-- budget and trade. To help correct a large trade deficit, a lower dollar is necessary. A lower dollar reduces the net returns to the foreign investors who help fund the budget and trade deficits. Nominal interest rates then must rise to offset the actual or prospective losses because of currency depreciation. Foreign investors always can be induced to absorb a fair share of the necessary financing--the issue is at what price.

Second, a lower dollar suggests increased future economic growth and possibly higher inflation, especially if excessive federal budget deficits are in prospect at the same time. Faster growth and high inflation tend to raise interest rates.

Third, a lower dollar presents a problem to the Federal Reserve. Even if desired, any unilateral easing would tend to lower the dollar more. Given the expected effects of a lower dollar on growth and inflation, interest rates may not decline. With the usual effects from easing monetary policy not possible, the central bank can find itself "hamstrung."

The risks to the U.S. financial markets and the economy of the dollar problem are clearly present now, where a taste of dollar-related jitters and fears of too strong growth and higher inflation are being reflected in a modest upward spike of interest rates. The large U.S. trade deficits, which stem in part from linkages to the budget deficits, depress the dollar. A lower dollar causes expectations of inflation and more growth later on. To finance the budget and trade deficits, interest rates rise to attract sufficient funds, both domestic and foreign. But prospects of higher inflation from the stimulus of excessive budget deficits and an expected improvement in trade and the industrial sector prevent inflation-adjusted interest rates from rising sufficiently to attract investors. The dollar remains under pressure and interest rates keep rising. In such a situation the Federal Reserve is trapped, unable to stop the rising trend for interest rates on its own.

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If interest rates rise sufficiently, by one or two percentage points, growth would be threatened and perhaps aborted. Too high inflation, high nominal interest rates, and stagnation is a possible result.

The rises of interest rates so far range from 25 to 50 basis points in just a week or two. Several short- and long-term interest rates are higher now than as far back as May 1986. Without policy actions to reduce the budget deficits or stop the decline of the dollar, interest rates could move much higher. Although initially relatively immune to the upticks of interest rates, the stock market would suffer jitters, too. Eventually, the U.S. economy could lose the new momentum it has only recently started to gain.

Though the current jitters may pass, they represent a possible fly in the ointment which otherwise is a reasonably positive outlook for 1987 and 1988. 1989 is another matter.

Features of the Outlook--

Sustained Economic Growth... 2-1/2% to 3% in 1987, 3%+ for 1988

Sustained growth, at least through 1988, is once again a feature of the Shearson Lehman projections, as has been the case for several years now.

Why sustained growth? First, the low inflation, low interest rates, a lower dollar, and the strong stock markets of recent years in the U.S. and rest of the world should help sustain the expansion. The lower dollar is a negative for countries such as Japan and Germany, limiting exports and reducing industrial activity, but is a major seed of improved growth in the United States.

Second, the worst seems over for the beleaguered sectors of the U.S. economy--manufacturing, mining and agriculture. The most recent data on employment and production in manufacturing indicate an upturn during the fourth quarter and in January. Mining production rose in December, suggesting an end to the downturn in oil and gas activities. Higher oil prices are helping oil and gas as well.

Table 1
Shearson Lehman Forecast of the U.S. Economy and Financial Markets*
January 27, 1987
(Probability=0.65)

	Quarters						Years			
	1986:3	1986:4	1987:1	1987:2	1987:3	1987:4	1985	1986	1987	1988
Gross National Product-1982 Dollars	3686.4	3702.4	3720.7	3748.3	3782.8	3813.8	3585.2	3676.5	3766.4	3886.6
Annual Rate of Change	2.8	1.7	2.0	3.0	3.7	3.3	2.7	2.5	2.4	3.2
Percent Change Year Ago	2.3	2.2	1.8	2.4	2.6	3.0	2.9	2.2	3.0	3.3
Consumption	2448.0	2445.1	2446.3	2460.5	2480.9	2503.6	2324.5	2418.6	2472.8	2552.0
Annual Rate of Change	6.7	-0.5	0.2	2.3	3.4	3.7	3.5	4.0	2.2	3.2
Business Fixed Investment	454.4	451.0	447.3	444.2	442.6	441.9	461.4	455.0	444.0	458.2
Annual Rate of Change	-2.1	-3.0	-3.2	-2.7	-1.4	-0.6	9.0	-1.4	-2.4	3.2
Residential Construction	197.2	199.3	196.1	194.1	196.5	198.0	177.3	193.9	196.2	199.3
Inventory Investment	-0.3	-11.5	14.5	20.2	23.1	18.7	9.0	10.8	19.1	22.3
Net Exports	-163.3	-155.6	-140.2	-131.8	-123.0	-116.8	-108.2	-149.7	-128.0	-111.1
Federal Government	330.9	353.5	333.9	335.8	336.4	341.4	323.6	333.4	336.9	336.2
Annual Rate of Change	2.5	30.2	-20.4	2.3	0.7	6.1	10.9	3.0	1.0	-0.2
State and Local Government	419.5	420.6	422.8	425.3	426.3	427.0	397.6	414.6	425.4	433.8
Annual Rate of Change	6.1	1.1	2.1	2.4	0.9	0.7	3.7	4.3	2.6	2.0
Industrial Production (1977=1.000)	1.250	1.260	1.271	1.285	1.301	1.320	1.245	1.251	1.294	1.356
Annual Rate of Change	1.9	3.2	3.5	4.5	5.1	6.0	2.3	0.5	3.5	4.8
Housing Starts (Mil. Units)	1.751	1.672	1.660	1.720	1.750	1.728	1.741	1.832	1.715	1.700
Auto Sales-Total (Mil. Units)	13.2	11.5	9.3	10.4	11.4	10.5	11.1	11.6	10.4	11.2
Unemployment Rate-Civilian (%)	6.9	6.8	6.8	6.8	6.7	6.6	7.2	7.0	6.7	6.4
Federal Budget Surplus										
Unified (Quarterly Rate, NSA, FY)	-53.9	-64.4	-46.3	-25.3	-53.5	-64.6	-211.9	-220.7	-189.5	-176.0
Implicit Price Deflator (%CH)	3.6	1.0	3.1	3.6	3.5	3.8	3.3	2.7	2.9	3.9
CPI- All Urban (%CH)	2.6	2.8	4.0	3.5	3.9	4.1	3.5	1.9	3.1	4.0
PPI-Finished Goods (%CH)	0.7	3.4	4.5	4.2	4.7	5.0	0.9	-1.4	3.2	4.2
Hourly Earnings (%CH)	1.2	3.1	2.3	2.9	3.2	3.3	3.0	2.4	2.6	3.2
Trade-Weighted Exchange Rate	1.028	1.027	0.979	0.971	0.979	0.990	1.272	1.060	0.980	1.030
Annual Rate of Change	-14.3	-0.3	-17.4	-3.2	3.3	4.6	4.0	-16.7	-7.6	6.0
Merchandise Trade Balance (Bils. $'s)	-175.6	-173.2	-141.8	-136.9	-131.9	-124.3	-148.5	-171.1	-133.7	-115.0
Corporate Profits Aftertax (Bils. $'s)	135.9	139.0	129.4	135.2	141.8	145.5	131.4	132.7	138.0	148.4
Percent Change Year Ago	1.9	-0.3	2.0	5.0	4.3	4.7	-6.3	1.0	4.0	7.9
Adjusted Profits Aftertax (Bils. $'s)	197.5	190.5	180.9	185.7	191.3	194.0	188.9	195.7	188.8	198.8
Percent Change Year Ago	-1.5	0.7	-9.9	-4.4	-3.1	1.8	11.6	3.6	-4.0	5.8
Real Disposable Income (Bils. $'s)	2605.6	2602.4	2636.8	2661.3	2688.2	2717.3	2528.0	2603.8	2675.0	2777.2
Annual Rate of Change	-3.0	-0.5	5.4	3.8	4.1	4.4	2.4	3.0	2.8	3.8
Personal Saving Rate (%)	3.1	2.7	3.9	4.1	4.3	4.4	4.8	4.0	4.2	4.6
M2 (Bils. $'s)	2721.4	2783.7	2837.8	2884.7	2937.9	2998.7	2551.7	2783.7	2998.7	3232.9
Annual Rate of Change	11.6	9.5	8.0	6.8	7.6	8.5	8.8	9.1	7.7	7.8
Prime Rate (%)	7.85	7.50	7.50	7.08	7.00	7.25	9.94	8.33	7.21	7.88
Federal Funds Rate (%)	6.21'	6.27	5.93	5.56	5.85	6.15	8.10	6.81	5.87	6.38
3-Month Treasury Bill (%)	5.52	5.35	5.46	5.21	5.27	5.44	7.48	5.98	5.35	5.78
10-Year Treasury Bond (%)	7.31	7.26	7.14	6.95	7.11	7.34	10.62	7.68	7.14	7.57
30-Year Treasury Bond (%)	7.41	7.53	7.47	7.25	7.35	7.60	10.79	7.80	7.42	7.81
New AAA-Equiv. Corporate Bonds (%)	8.56	8.44	8.35	8.02	8.21	8.48	11.03	8.65	8.27	8.68
Bond Buyer Index (%)	7.28	6.93	6.77	6.60	6.75	6.98	9.11	7.32	6.78	7.15
S&P Index of 500 Common Stocks	241.15	242.97	269.12	282.12	289.93	287.36	189.59	236.17	282.13	294.29
Annual Rate of Change	1.0	3.1	50.5	20.8	11.5	-3.5	18.2	24.6	19.5	4.3
Earnings Per Share - S&P 500 ($)	3.85	2.94	3.57	3.78	4.20	4.32	14.61	14.43	15.87	17.85
Price-Earnings Ratio - S&P 500	16.3	16.8	19.0	20.0	20.0	18.1	13.0	16.4	17.8	16.5

** Includes estimated affects of Tax Reform Act of 1986*

Forecast Assumptions—U.S. Economy and Financial Markets

Fiscal policy—budget and taxes: With or without the Gramm-Rudman-Hollings statute, fiscal policy is no longer providing much stimulus to the economy. Under the Shearson Lehman economic outlook and current law, the deficits without GRH would be $210 billion, $205 billion, and $195 billion for FY1988 to FY1990. The averages of the Administration and CBO forecasts as of January 1987 are $160 billion for FY1988, $155 billion for FY1989, and $130 billion for FY1990.

Even with $30 billion in budget savings from the revenue gains of tax reform, the 1986 Reconciliation Act and other changes, the budget deficit is estimated by CBO and the Administration to be near $175 billion in FY1987. In FY1988, the Administration projects a deficit of $107.7 billion, just under the GRH target. The CBO estimate is $135-to-$140 billion.

Given over-optimistic economic assumptions by the government, deficit reductions that may not be bona fide, and underestimates of defense and agriculture spending, the Shearson Lehman forecast of the FY1987 unified budget deficit is $189.5 billion. For FY1988, the forecast is $176 billion, assuming about $35 billion reductions in spending.

The deficits over the next few years are likely to be well above the GRH targets, even with $30-to-$35 billion in achieved savings. Under OMB and CBO assumptions, the required cuts from FY1988 to FY1990 would be $52 billion, $83 billion, and $94 billion, respectively. Under Shearson Lehman's less optimistic current services baseline the necessary cuts are even larger at $102 billion, $133 billion, and $159 billion from FY1988 to FY1990. Such cuts are huge and improbable. Bona fide reductions of about $35 billion in FY1988, $40 billion in FY1989 and $54 billion in FY1990 are assumed.

Over five years, the Tax Reform Act of 1986 is essentially growth-neutral for the economy. But, near term, a net $14 billion tax increase (a $33 billion tax hike on business and a $19 billion tax cut for households) for calendar 1987 will be restrictive, with negatives on business capital spending and commercial construction outweighing the positive effects on consumption.

Real economic growth in 1987 is 0.5 percentage points lower than otherwise because of the tax bill, especially in the first half. Growth should be higher in 1988 and 1989, by 0.3 and 0.2 percentage points, respectively, because taxes, net, are reduced. Growth in business fixed investment is two percentage points lower in 1987 from the tax bill, then returns to the pre-tax bill track. Consumer spending picks up in the second half of 1987 and in 1988 as a result of the tax bill. Corporate aftertax profits are weaker in 1986 and 1987 from the tax bill.

Monetary policy: Accommodative through the remainder of the year and next because of sluggish growth in the U.S. and world economies. With elevated concern over the dollar, the central bank is seen as reluctant to ease without interest rates moving lower in the countries of major trading partners. Along with economic growth, the dollar is fundamental for the Fed. Real GNP growth of 1-1/2% or less is the dividing line between further easing or holding on policy. One more discount rate cut is assumed to occur in the second quarter.

Policy mix: The "loose fiscal-tight money" policy mix in place from 1981 to 1985 has shifted. Fiscal policy is being gradually tightened and monetary policy has been easier. The reductions of the budget deficits set into motion over 1982 to 1985 and the suspension of monetary growth targeting have produced a permanently lower profile of interest rates, higher equity prices, and a weaker dollar than otherwise would have been the case. Over time, if the twist in the policy mix is maintained, a rebalancing of the economy's imbalances should occur, with interest- and dollar-sensitive sectors such as trade, net exports, and manufacturing all performing better.

Oil prices: More stable oil markets over the next few months, with crude oil prices settling between $17 and $19 per barrel for North Sea Brent and West Texas Intermediate crudes and near $17 a barrel for refiners' acquisition costs. The new OPEC Agreement holds through midyear and a new one is set thereafter. The $11 a barrel net drop in refiners' acquisition costs since last November now assumed reduced inflation by several percentage points in 1986, fully offsetting the inflationary effects of a lower dollar. A deflationary effect on business costs lingers in 1987, but inflation rates rise from the latest crude oil price hikes, the declines in the dollar, and a stronger economy. A range of $16 to $19 a barrel is projected for oil prices in 1987, $18 to $21 a barrel in 1988, and $20 to $23 a barrel in 1989.

Commodity prices: A firming of basic commodities prices as the industrial sector revives but no surge of inflation, reflecting the still large supplies and slack demands in economies throughout the world.

Wages and unit labor costs: In general, continuing modest rises in wages because of economic slack, the effects of deregulation, intense product and labor market competition, and the decline in union strength. A tough stance by management is assumed to keep rises in wages on a low track. Productivity growth should pick up with increased industrial output and benefit from the lower energy prices, net, in 1986-87. Unit labor cost increases of 1.5% to 2.5% per annum for 1987 and 1988 are expected. These small rises in labor costs are a major factor in the subdued inflation that appears in the forecast.

Third World debt and bank problems: Major debtors turn to the banks to negotiate new loans in 1987, notably Brazil, Argentina and the Philippines. Mexico should start negotiations in mid-1987 for 1988 borrowing needs. South Korea will leave the list of problem countries as its current account balance moves firmly into surplus. Bank balance sheets and debtor countries' problems should be eased from a trend to swap debt for equity, and eventually to securitize LDC loans. Banks will continue to build up reserves against loans to the big debtors. Growth in the developed world is not sufficient to rally energy or commodity prices, and a slowdown in U.S. imports assures that LDC liquidity problems will remain.

Growth in the rest-of-the-world economies: With sluggish growth abroad, pressure continues on Germany and the Japanese to undertake more expansionary policies, open their economies, and continue lowering interest rates. Growth is weak but somewhat better in Japan in 1987 and still sluggish in Germany. Unemployment declines a little in Europe, but continues to be a major economic problem. In Japan, unemployment will rise to record highs. Another round of lower interest rates abroad is assumed in the first half of 1987.

The dollar and trade legislation: The fundamentals point to a lower dollar yet, with fluctuations between 1.7 and 1.9 deutschemarks, from 145 to 155 yen, 6 to 6-1/4 French francs, and 1.50 to 1.55 on the British pound sterling. A 5%-to-10% drop against the Morgan Guaranty trade-weighted exchange rate is expected by mid-1987 compared with 1986 averages, but the dollar at year-end should be stronger than at mid-1987. The strong currencies for the U.S.'s major trading partners have permitted some easing of monetary policies and helped to lower interest rates. But, if further interest rate reductions do not occur abroad and the U.S. trade deficit does not show a significant improvement, the dollar will push even lower, heading for 1.6 deutschemarks, 135 yen, less than 6 francs, and 1.60 or more on the pound sterling.

Trade frictions are assumed to mount in 1987. Protectionist legislation occurs by mid-year, but not in a severe form as a compromise between a Senate trade bill and Administration proposals is reached.

Third, the policymakers of the Western industrial world continue to practice a "fail-safe" approach, injecting stimulus whenever economies seem to falter. The latest examples include the reduction in the discount and Lombard rates by West Germany. The doses of stimulus lately have been small, as countries try to avoid too rapid growth and maintain sustained, noninflationary growth.

Finally, the usual excesses and imbalances that normally precede a recession in the United States are not yet present. Growth has been slow enough to prevent them from arising. Indeed, a massive liquidation of inventories by the business sector last year has removed one of the worrisome excesses from the economy.

The prospect of sustained growth in the economy for 1987 and 1988 now is widely accepted and has been a positive fundamental for U.S. equity markets.

But Moderate...Weaker Early, Stronger Later
Why is growth expected to be only moderate? There are three reasons. First, the economy is continuing to adjust to the transition to a services economy from a goods economy. Although the worst seems to be over for the "goods" sectors of the economy, adjustments still are being carried out.

The second reason is the big trade deficit, approximately $170 billion for 1986, a problem of "external balance." In order for the trade deficit to move lower, one adjustment other than a depreciating dollar is for the U.S. to grow more slowly than its major trading partners. In such a case, fewer goods would be bought from abroad and more exports purchased from the U.S.

A problem is that the major trading partners of the U.S. are targeting lower growth rates than before. Japan has targeted a 3-1/2% growth rate; previously more than 4% was desired. Moreover, a 3-1/2% growth rate appears unattainable. In actuality, about 2-1/2% is likely (Table 2). Germany has targeted a 3% growth rate, although actually forecasting 2-1/2%. Growth of 2-1/2% may be difficult to attain.

As long as the trading partners of the U.S. accept less growth than before, the U.S., too, will have to accept slower growth than before. Otherwise, the U.S. trade deficit could worsen, or not improve very much.

The third reason for modest growth, especially early in 1987, is the Tax Reform Act of 1986, which, on balance, is restrictive this year. Business taxes will be higher by $25 billion in 1987 while consumers receive approximately a $15 billion tax cut. The net is a $10 billion tax increase. This should lower economic growth by 0.5 percentage points from what it would otherwise have been, mostly in the first half. Although consumers eventually will spend more because of the personal income tax cuts, such action will come later in the year after a period of consolidation and saving.

Slow growth is not all bad. It prevents demand-pull inflation from appearing quickly and it can avoid significant upward pressure on interest rates from domestic credit markets. Thus, the equity markets, very rationally, have viewed slow to modest growth as a plus.

A Better Balanced Economy--Shifting Gears

The economy is shifting gears to a different mix of strengths and weaknesses in the various components of real GNP activity. Trade, real net exports and the industrial sector, the weakest areas of the past year, should do better. In contrast, consumer spending and housing, driving forces in the economy this past year, will show less strength.

The emerging shift in the composition of spending shows up clearly in recent data. In the fourth quarter consumer spending declined, housing weakened and real net exports improved, with a good-sized upturn in exports across-the-board, at least in the inflation-adjusted GNP data.

Orders, production, and employment have been rising for several months. Employment growth, in particular, has been most impressive, rising over 225,000 on the nonfarm payroll basis, for five consecutive months. Inventory-sales ratios in manufacturing are at or near the lows for the current expansion, indicating a need for inventory rebuilding.

For merchandise trade, an improvement of $35 billion to $40 billion is forecast over 1987. The weaker dollar and soft export prices are helping exports. Weaker consumer and business spending in the first half should reduce the volume of imports. Adjusted for inflation and converted into the GNP accounts, the improvement in real net exports should add 0.7 percentage points to growth in 1987. One result is a 3-1/2% increase for industrial production. This is the best increase for industrial production since 1984, and would be a definite sign of improved health in the industrial sector.

In 1987, consumer spending is projected to rise at a 2.2% annual rate, down from the 3-1/2% to 4% rates of 1985 and 1986. The weakness is concentrated in the first half, with consumer spending increasing at a 1% to 2% annual rate, as consumers replenish savings. Consumer spending should come back stronger in the second half due to the $15 billion tax cuts for households this year and the $30+ billion of tax cuts in 1988 and in 1989. Residential construction is expected to rise only a little this year, much less than in 1986. Here, too, the second-half performance should be better, especially in housing starts and home sales, if interest rates stay reasonably stable.

Inflation--Worse, But Not Bad

Inflation is likely to be worse in 1987 than in 1986, but still not bad. It would be hard to beat last year's outstanding performance, the best since the early 1960s. For 1987, inflation is projected to be in a range of 3% to 3-1/2%. Inflation rates should accelerate as the year progresses, however, with quarterly rates of inflation later in the year possibly over 4%.

There are three positives for the inflation outlook. First, too many goods still are chasing too few dollars. With a lot of slack still in world economies, no demand-pull inflation of consequence can yet be seen. Second, unit labor costs are rising slowly. Average wage compensation is increasing at about a 2% to 3% annual rate. Though overall productivity growth has been weak, in manufacturing it is back up to trend, which should keep unit labor costs in the 1-1/2% to 2-1/2% range. The third factor is heavy product market competition, here and abroad, that continues to keep prices under pressure.

There are also three negatives for inflation. One is higher oil prices, which should bubble up into the inflation data in February, March and April. The second is the lower dollar and higher import prices, which will increase costs for many businesses and raise consumer goods prices for some categories of items. So far, the effect of the lower dollar has been small, because the economy has been so weak that price increases couldn't be passed on. But the effect will build over time. The last negative for inflation is protectionism. A number of trade measures, tariffs, and quotas have been adopted or are in the works, and eventually will have inflationary effects.

This inflation picture, while probably a negative for U.S. fixed income markets, is a plus for equities. For awhile, accelerating inflation can be a plus, pushing revenues and profits higher for many companies. Ultimately, high and accelerating inflation, if sustained, is negative for both the bond and stock markets.

Corporate Profits--Improving in Quantity and Quality
Corporate profits should improve in 1987 and 1988, both in quality and quantity.

Corporate aftertax profits are projected to be up 4% in 1987 and by 7.9% in 1988. These figures are considerably better than the results for 1985 and 1986, and would be even higher if not for the Tax Reform Act of 1986.

For this year, the S&P 500 company earnings figures may provide a better measure than the aggregate profits data of the Department of Commerce, because individual company earnings will be less distorted by the Tax Reform Act. For the S&P 500 earnings-per-share data, the big negative from the tax bill occurred in the fourth quarter of 1986, where the retroactive elimination of the investment tax credit shows up. The prospects are a good deal better for 1987 and 1988, when deferred tax liabilities for many companies will be taxed at lower rates. A 10% increase for the S&P 500 earnings-per-share is projected in 1987, and a 13% rise in 1988.

Essentially, corporate profits are headed higher because sales will be up and export earnings should do better. Because business costs have been cut back substantially, any increase in sales will be highly leveraged into higher earnings.

Interest Rates--Relatively Stable, But Risks Near Term

Long-term interest rates should remain in a trading range, but with a significant risk of increases over the next month or two, related to the dollar freefall and uncertainties over growth, inflation and policy prospects, here and abroad.

The 30-year Treasury bond yield is projected to fluctuate between 7-1/4% and 7-3/4% for much of the first half of 1987, with possible upward spikes to as high as 8%. Upside risks of 25 to 50 basis points exist near term, a consequence of better growth to come and interest rate pressure from a weak dollar. Rates will probably move somewhat lower in the second quarter before tilting higher later in the second half when economic growth strengthens. Other bond yields likely will follow a similar pattern, with new issue long-term AAA-corporate bonds trading between 8% and 8-3/4% through much of the year.

Short-term interest rates are approximately fixed now in alignment with the 5-1/2% discount rate and are unlikely to change much without a shift in Federal Reserve policy. Short-term interest rates are not immune from the dollar problem, however, and could spike upward as well. Currently, the Federal Reserve is "hamstrung," unable to ease unilaterally because of the dollar; probably not even in the face of lower interest rates abroad, at least initially, if they were to occur.

No change in Fed policy is expected before April or May, when sluggish growth in Japan and Germany are expected to combine to produce another dose of lower interest rates. The three-month Treasury bill rate should stay in a 5-1/2% to 6% range through February, moving down toward 5-1/4% with the help of a discount rate cut later in the Spring. The prime rate has been forecast to remain at 7-1/2% into the second quarter, then to drop to 7% by summer. Odds now on these reductions have dropped to less than 50-50.

Growth in the 2% to 3% Range in the Rest-of-the-World Economies

The major world economies are expected to grow more strongly towards the end of 1987 after a rocky first half of the year (Table 2 and assumptions). Average economic growth in the OECD countries should remain about the same as in 1986, but the composition of growth 'will be different. West Germany is forecast to average the same as or a slightly lower growth rate than last year. Growth in Japan, France, Italy and the United Kingdom will accelerate by about half a percentage point each. The more commodity-oriented economies such as Canada and Australia will weaken. The variance of growth rates over the year will be wide: Germany and Japan should exhibit slow or even negative growth in the first quarter of the year as the deflationary impacts of their appreciating currencies work through their economies and severe weather takes a toll.

Inflation is expected to pick up a notch, but to remain well below the levels of the past few years. For the OECD economies, inflation rates could pick up about half a percentage point, on average. The benign effects of declining oil prices and appreciating non-dollar currencies that contributed to the fall in inflation in 1986 are not a part of the 1987 outlook.

Table 2
World Outlook Summary
(History and Shearson Lehman Forecast)
January 27, 1987

	Real Growth* (Percent Change)				Inflation-Consumer Prices (Percent Change)				Unemployment Rate (Percent)				Current Account Balance** (Billions of U.S. Dollars)			
	1984	1985	1986	1987	1984	1985	1986	1987	1984	1985	1986	1987	1984	1985	1986	1987
United States	6.6	2.7	2.6	2.5	4.3	3.5	1.9	3.0	7.5	7.2	7.0	6.7	-107.4	-117.8	-142.7	-107.0
Canada	5.5	4.0	3.4	3.1	4.3	4.0	4.2	3.4	11.3	10.5	9.6	9.2	2.6	-0.4	-6.5	-3.2
Europe	2.3	2.5	2.4	2.7	5.9	5.2	2.5	3.0	10.5	10.8	10.9	10.6	4.7	14.7	41.0	21.0
France	1.5	1.4	2.4	3.0	7.7	5.8	2.5	2.7	10.0	10.3	10.4	9.9	-0.8	0.2	2.6	5.5
West Germany	3.0	2.5	2.5	2.4	2.4	2.2	-0.2	1.2	9.1	9.3	8.9	8.9	6.8	13.9	36.8	20.5
Italy	2.8	2.3	2.7	3.0	10.5	8.6	6.2	4.7	12.1	12.9	13.8	13.1	-2.9	-4.2	2.8	-3.0
United Kingdom	1.8	3.8	2.1	2.6	5.0	6.1	3.4	3.6	11.7	11.8	11.9	11.6	1.6	4.8	-0.6	-2.0
Far East	5.7	4.4	2.8	3.0	2.8	2.5	1.7	1.8	—	—	—	—	37.0	55.0	93.7	82.6
Japan	5.0	4.7	2.3	2.7	2.3	2.0	0.6	1.1	2.7	2.6	2.8	3.2	35.0	49.2	84.0	75.0
South Korea	8.6	5.2	12.2	7.1	2.4	2.5	2.3	2.5	—	—	—	—	-1.4	-0.9	5.0	4.5
Taiwan	9.6	4.3	10.8	6.8	0.2	0.4	0.7	1.2	2.4	2.9	2.7	2.9	7.0	9.3	14.0	8.0
Hong Kong	9.8	0.8	5.2	4.8	4.7	2.6	4.1	3.7	—	—	—	—	-0.3	0.5	0.0	1.0
Indonesia	5.8	1.0	0.4	2.5	10.5	4.7	5.8	4.8	—	—	—	—	5.7	5.8	2.2	2.5
Singapore	8.2	-1.8	1.9	2.8	2.6	0.5	0.1	0.5	—	—	—	—	-0.7	-0.3	-1.0	-1.2
Australia	6.9	4.4	1.1	1.8	4.0	6.7	8.8	6.4	9.0	8.2	8.1	8.6	-8.3	-8.6	-10.0	-6.7
Latin America	3.4	3.9	2.8	2.9	195.3	201.9	102.3	54.6	—	—	—	—	6.7	3.1	-7.9	-7.0
Argentina	2.4	-4.5	3.0	3.0	626.7	672.2	90.1	45.0	—	—	—	—	-2.5	-1.0	-3.2	-3.0
Brazil	4.5	8.3	9.1	4.6	223.8	235.1	158.6	72.0	—	—	—	—	0.0	-0.3	-1.2	-1.9
Mexico	3.7	2.7	-3.5	1.1	65.5	57.2	86.1	65.0	—	—	—	—	4.2	0.5	-2.2	-2.4
Venezuela	-1.1	0.3	-2.0	1.7	18.3	9.1	10.6	8.9	—	—	—	—	5.0	3.9	-1.3	0.3
All Countries Listed	5.2	3.1	2.7	2.7	15.7	15.5	8.1	5.9	—	—	—	—	-56.4	-45.4	-22.4	-13.6
OECD Countries Listed	5.2	3.1	2.5	2.6	4.3	3.8	2.1	2.8	7.6	7.5	7.4	7.3	-73.4	-62.9	-34.0	-20.9
EEC	2.3	2.5	2.4	2.7	5.9	5.2	2.5	3.0	10.5	10.8	10.9	10.6	4.7	14.7	41.0	21.0

** Real GNP or GDP, depending on the country*

*** Hong Kong and Indonesia, trade balance*

Forecast Assumptions—Rest of the World

France: The Chirac Conservative government's program of denationalization and liberalization of capital markets will continue, despite labor unrest in early 1987. Conservatives are likely to wrest the presidency from the Socialists in the upcoming elections. The 1987 budget is the first in 28 years to cut real expenditures. The deficit will shrink to 2-1/2% of projected GDP in 1987 from 3% in 1986, and the government plans to reduce the deficit by Fr 15 billion in each budget to 1989. Tax reform will lower both personal and corporate rates but expand the tax base. Monetary policy shifts to interest rate management in 1987 after many years of direct credit and foreign capital controls. Targets of 3% to 5% for M2 match with anticipated 5% growth of nominal GDP, but nominal interest rates should decline somewhat to catch up with the deceleration of inflation that occurred in 1986. The franc should remain strong against the dollar, trading in the Fr 6 to Fr 6.25 range.

Germany: The victory of the center-right coalition in the January 25 election promises a continuation of the Kohl government's broad economic policies of fiscal and monetary conservatism. Government spending is expected to remain flat in 1987 and the deficit will be essentially unchanged from 1986 as a share of GNP. The government will propose revenue-neutral tax reform for debate in 1987 and implementation in 1988. The 1987 growth targets for Central Bank Money—set at 3% to 6%—are wider than last year, lessening the odds on any further change in monetary policy. Currency intervention early this year will keep growth in CBM high, making an additional easing in monetary policy less likely in the first half. But at some point, continuing weak real growth and external pressure should bring another easing by the Bundesbank. The deutschemark will continue to appreciate against the EMS currencies and the dollar in 1987, ranging from DM 1.7 to DM 1.9 vs. the dollar and stabilizing near DM 1.8 by year-end.

Italy: The Craxi coalition remains in the government, but the balance of power is too fragile to get the kinds of expenditure reductions needed to dent the public sector deficit—the overwhelming economic problem. The 1987 draft budget was not approved by January 1 but should pass Parliament early in the year. The final resolution will be considered a success if the government deficit does not exceed last year's. Interest rate reductions should catch up with the deceleration of inflation that occurred in 1986, but real rates will remain high as public financing bumps against fixed ceilings on domestic credit. The exchange rate should fluctuate between Lit 1250 and Lit 1350 against the dollar while slowly sliding against the deutschemark. The trade and current account deficits will improve in 1987 because oil prices will be lower, on average, than in 1986. Tourism will pick up again in 1987 and 1988.

United Kingdom: Polls indicate Thatcher's Conservatives and the Labour opposition are tied, pushing elections off until very late this year or early in 1988. Assuming a continued Tory government, the 1987/88 budget will aim to keep spending as high as the level already delivered by the autumn budget supplement. Revenues will continue to be enhanced by sales of public assets through 1989, postponing a budget crisis and allowing the promised reductions in personal tax rates for both 1987 and 1988. Monetary policy will be keyed on the value of the pound—current speculation against the sterling has pushed real interest rates higher in England than elsewhere in the developed world. Firmer oil markets in 1987 should help the sterling, allowing interest rates to drift downward later. High wage increases point to more inflation down the road, however, and are symptomatic of a major problem still facing the British economy.

Japan: The LDP will have to select a new leader in 1987 as Mr. Nakasone's exceptional term extension expires. The budget for fiscal 1987/88 is the most austere in 22 years with virtually no increase in overall expenditures. The stimulus of the 1986 supplemental budget will not be carried forward, unless spending is augmented in the summer. Japan remains committed to eliminating public sector borrowing by 1990. Tax reform will lower personal and corporate tax rates, but new taxes and fees will balance the program and leave revenues unaffected. Monetary policy is not a top priority, and the monetary growth target will remain around 8% through 1988 despite low inflation and sluggish growth. Official short-term interest rates have been pushed quite low, but long-term rates can ease. The Bank of Japan will intervene as needed to try and hold the exchange rate between ¥150 and ¥160 to the dollar. But, if the U.S. deficit does not improve early in 1987, the exchange rate would slip to ¥145 or so.

Canada: With no impending governmental crises, the Mulroney government is relatively free to address the issues of unemployment, the public sector deficit, and trade. The FY1986/87 budget fell short of its goal to bring public borrowing under C$30 billion, and the FY 1987/88 budget can improve on that performance only by cutting expenditures—a difficult task with high unemployment. Tax reform is under study, but will not likely become reality until 1988 when U.S. tax reform comes into full force. Monetary policy is committed to defending the Canadian dollar, and short-term interest rates could rise early in 1987 as pre-budget speculation mounts. After the defense of the currency, interest rates should move in parallel with U.S. rates, although the spreads would widen if the exchange rate remains unchanged. Trade negotiations with the United States will produce disappointing results in 1987—small issues will continue to cloud overall trade relations.

East Asia: The stellar growth of 1986 will continue at a slightly dampened pace in 1987 and 1988. Taiwan will see foreign demand slacken in 1987 and 1988 as the U.S. and Japan cut back on import demand. South Korea should have another strong year as new industries open up export opportunities—especially in cars and electronics—and export-led growth continues. Hong Kong should benefit from China's improved import position. Generally, exports should lead this economy up as well. Singapore's recovery from the 1985-86 recession will solidify in 1987, but exports will not be strong enough to return the country to its historically high growth rates.

Latin America: Mexico will elect a new president in 1988 and politics could turn less flexible to the country's creditors as early as 1987. National elections are also expected in Brazil and Argentina within the next 18 months. Economic restructuring plans are disintegrating in both economies, and external deficits are widening. In 1987, new loan requests considered by the world banking community will be resolved on a case-by-case basis, but most banks will be reluctant and ungenerous lenders. Inflation is accelerating in all of the major Latin economies. Debt-for-equity swaps will be the dominant source of new lending over the next two years through the discount market, and some form of securitization of LDC debt will be implemented. Commercial banks will continue to increase reserves against Latin American loans.

In trade, the imbalances of 1986 are expected to ease somewhat. In 1987, the U.S. current account deficit should narrow and the West German and Japanese surpluses should decrease as well. The paramount economic problem will be unemployment, which is expected to fall less than one-half percentage point in Europe. Unemployment rates should rise to record highs in Japan. Increasing average growth rates for the whole of 1987 disguise the effects of the weakness early in the year.

Interest rates worldwide will continue to decline in 1987 (Table 3), although a slight pickup in inflation near year-end will push rates up slightly by the fourth quarter. Short-term interest rates generally should ease in the first half of the year before rising somewhat in the second, in response to sluggish growth and easier monetary policy. Long-term rates are also expected to decline slightly through the middle of the year. This synchronization of world interest rates means a more stable dollar for 1987 as a whole, and possibly some strengthening of the U.S. currency by the fourth quarter. But between now and then, the dollar can drop another 10% to 15% against key currencies. However, if the U.S. trade and current account deficits do not show improvement, the dollar would continue its slide and set further record lows against the yen and the European currencies.

The dollar is forecast to decline against the major currencies (Table 3). In the absence of agreement by the major trading partners, further declines of 10% to 15% are possible. Ultimately, despite early slow going, some agreement on currencies and policies likely will emerge.

The Federal Budget Deficit--Prospects and Perspectives

The federal budget deficits remain too high, especially as the U.S. economy begins to head for faster growth. Estimated under current conditions and reasonable expectations for the U.S. economy, Congressional deliberations, and Administration reactions, unified budget deficits are likely to be $189.5 billion in FY1987, $176 billion in FY1988, $164.5 billion in 1989 and $141.4 billion for 1990, far above government estimates and the targets set by the Gramm-Rudman-Hollings (GRH) legislation. On a structural or cyclically-adjusted basis, the deficits should be $167 billion in FY1987, $156 billion in FY1988, reaching $109 billion in FY1990.[1] These projections already reflect expectations of reductions in federal government spending of $34 billion, $40 billion and $54 billion in fiscal years 1988 to 1990, relative to the current services baseline, not yet approved and effected by the Congress.

Although the federal budget deficits do seem to be headed lower, regardless of how measured or by whom, no longer to soar so long as the economy keeps expanding, they are too high because severe imbalances are created from the impacts of the deficits on interest rates, the dollar, the trade deficit, the economies of the U.S. and the rest-of-the-world, and patterns of performance across industries and geographic regions. For the first time in postwar U.S. economic history, large and excessive budget deficits have principally acted to "crowd-out" foreign trade and the industrial sector, "crowding-in" consumption spending instead and creating imbalances and risks for the financial markets, the U.S. economy, and rest-of-the-world economies that must be resolved in order to achieve noninflationary growth here and abroad.

Indeed, as the U.S. economy begins to recover from the pronounced weakness of the past two years, it is necessary that the federal budget deficits be reduced by more than currently is in prospect to provide room for the private sector to keep growing. Structural budget deficits, estimated by Shearson Lehman Economics to range from $167 billion to $109 billion over the next few years, even though declining, are too high for growth without the accelerating inflation, overextension, and higher interest rates that typically set the stage for a business cycle downturn.

A point of no return has been crossed where it is now counterproductive to explicitly and actually meet the GRH targets. Even if attempted, the necessary adjustments by the Federal Reserve to compensate for the lost economic activity could not be taken quickly enough nor coordinated well enough to smooth the adjustment process in an economy that is already fragile. The central bank would have to quickly reduce interest rates by at least several percentage points, almost impossible to do with enough lead time to revive an economy already depressed by the large deficit reductions necessary to reach the GRH targets. By attempting to do so, the central bank would inject a great deal of volatility into a risk-prone economy through large swings of interest rates. With 12% of goods consumed here purchased abroad and 37% of business equipment spending imported from the rest-of-the-world, any slowdown in the U.S. economy could translate to a similar pattern of weakness abroad. The additional dollar weakness likely if the GRH targets were achieved also would risk further depression of the recessed export and industrial sectors in Japan and Germany.

The problem with attempting to meet the GRH targets is that the legislation, as currently constituted, involves an inherent flaw. The unified budget deficits from which the deficit reductions necessary to reach the GRH targets are calculated reflect the performance of the economy. A subpar economy is reflected in higher-than-expected unified budget deficits. In turn, the calculated reductions to meet the GRH targets are larger. Those reductions, if carried out, tend to depress the economy. The ex-ante reductions in deficits then do not occur, ex-post, and further large deficit reductions are required. Although the GRH legislation contains a trigger mechanism that shuts off spending cuts once real growth declines, the negative growth would be perceived too late to prevent accelerating weakness. U.S. economy weakness tends to depress the dollar, which offsets the usual lower interest rate effect from weak growth.

The ideal approach would be 1) to use the cyclically-adjusted federal budget deficit as the base for calculating the necessary deficit reductions; 2) to use a combination of tax changes and spending reductions to establish a downward glide path for the deficits that is between what now appears most likely and the GRH targets; 3) apply a gradually easier monetary policy in advance of the budget cuts, and 4) obtain agreement from major trading partners to shift domestic policies toward more stimulus in return for more budget discipline in the U.S.

The tax increases need not be large or through higher personal income or corporate profits tax rates. This would be unwise and unnecessary, since the reductions in the budget deficits should be aimed at only a gradual elimination of the cyclically-adjusted budget deficits by the end of the decade. A combination of 1) modestly higher taxes--a $5 per barrel oil import fee or excise taxes on energy use and increased excise taxes ($10 billion to $15 billion a year); 2) reductions in both defense and nondefense spending ($20 billion to $40 billion a year); and 3) reductions of interest rates of one to three percentage points a year from the tighter budget and an easier monetary policy could pay handsome dividends in permanent deficit reductions at least cost to growth and inflation. The role of more stimulus in the rest-of-the-world would be to pick up some of the economic slack from a tighter budget that is not easily offset by the Federal Reserve.

Risks--Growing More Significant

The big risk is an upward spike on interest rates from a lower dollar. The uncertainty over how far the dollar might fall is a key concern in the government securities market, where foreign purchases are a major factor. A danger from the dollar's decline is poor foreign participation in Treasury auctions and higher interest rates. The lack of cooperation between the U.S., Germany and Japan is another negative for the bond markets. Nervous fixed income markets are expected for awhile, and further interest rate increases of 1/4 to 1/2 percentage points are quite possible.

The worry is that the central bank might have to tighten policy to "defend the dollar," raising interest rates and risking growth in interest rate sensitive sectors such as housing and capital spending. With the budget process moving slowly again and the policies of major trading partners out of synch, such a risk is significant.

Conclusion

By and large, the economy seems to be emerging from the doldrums, ready to enter a period of better, more balanced growth with inflation worse, but not bad, and corporate profits significantly higher. If interest rates can remain relatively stable, the economy should keep expanding through 1987 and 1988.

Potential cracks in the expansion are beginning to appear, however, the outgrowth of still excessive budget deficits, problems in trade, and with the dollar. If Congress and the

Administration fail to get the budget house in order and the U.S. and its trading partners fail to move toward complementary macroeconomic policies, then the usual business cycle sequence of higher inflation, higher interest rates and financial troubles may well appear to bring an end to the current, long business expansion. The business cycle has not been repealed! It will take hard work and judicious planning to realize the goal of sustained, noninflationary growth to the end of the decade.

Footnotes

[1] The structural or cyclically-adjusted budget estimates show the outlays, revenues and deficits that would result if the economy were at full employment, defined as a 6% unemployment rate and 2.8% growth in potential real GNP. This measure attempts to remove the effects of the economy on budget prospects and provides a better, although still imperfect, approximate measure of budget stimulus or restraint.

Table 3
Recent History and Prospects for the U.S. and World Economy
Exchange Rates and Interest Rates
January 27, 1987

	1985:1	1985:2	1985:3	1985:4	1986:1	1986:2	1986:3	1986:4	1987:1F	1987:2F	1987:3F	1987:4F	1985	1986	1987F
Exchange Rates															
United States (Weighted Avg.)	1.350	1.313	1.249	1.173	1.117	1.067	1.028	1.027	0.979	0.971	0.979	0.990	1.271	1.060	0.980
Japan (¥ per $)	257.5	250.8	238.4	207.2	187.8	169.9	155.8	160.5	152.0	148.2	145.1	147.0	238.5	168.5	148.1
West Germany (DM per $)	3.257	3.089	2.847	2.584	2.348	2.245	2.085	2.006	1.781	1.741	1.705	1.788	2.944	2.171	1.754
France (Fr per $)	9.958	9.422	8.681	7.886	7.212	7.141	6.779	6.571	6.001	5.710	5.652	5.781	8.987	6.926	5.786
United Kingdom ($ per £)	1.115	1.256	1.376	1.435	1.441	1.509	1.488	1.430	1.532	1.571	1.600	1.575	1.296	1.467	1.570
Canada (C$ per US$)	1.35	1.37	1.36	1.38	1.40	1.39	1.39	1.39	1.36	1.34	1.34	1.35	1.37	1.39	1.35
Short-Term Rates															
United States	8.2	7.5	7.1	7.2	6.9	6.1	5.5	5.4	5.4	5.2	5.2	5.4	7.5	6.0	5.3
Japan	6.3	6.3	6.3	7.0	6.0	4.7	4.6	4.6	3.9	3.8	3.8	4.0	6.5	5.0	3.9
West Germany	6.1	5.8	4.9	4.8	4.6	4.6	4.5	4.6	4.3	4.1	4.0	4.2	5.4	4.6	4.2
France	10.6	10.3	9.8	9.1	8.7	7.4	7.1	7.4	8.4	8.2	7.8	7.9	9.9	7.7	8.0
United Kingdom	12.4	11.9	11.0	11.2	11.6	9.5	9.6	10.2	10.9	10.5	10.3	10.4	11.6	10.2	8.1
Canada	10.4	9.5	8.9	8.9	10.8	8.5	8.4	8.4	8.6	8.2	7.9	8.0	9.4	9.0	8.2
Long-Term Bond Yields															
United States	11.6	11.0	10.6	10.0	8.8	7.5	7.6	7.5	7.5	7.3	7.4	7.6	10.8	7.8	7.4
Japan	6.6	6.4	6.1	6.3	5.2	4.9	5.1	5.3	5.1	4.9	4.8	4.9	6.3	5.1	4.9
West Germany	7.4	7.1	6.5	6.5	6.1	5.7	6.1	6.1	5.8	5.6	5.5	5.6	6.9	6.0	5.6
France	12.2	11.7	11.7	11.3	10.3	8.2	7.9	8.1	8.5	8.4	8.1	8.2	11.7	8.6	8.3
United Kingdom	10.3	10.3	9.9	9.9	9.5	8.7	9.5	10.1	10.4	10.2	10.0	10.1	10.1	9.5	10.2
Canada	11.9	11.0	10.9	10.4	10.0	9.4	8.9	8.9	8.3	8.4	8.2	8.3	11.0	9.3	8.3

Notes: Data are period averages; annual data are averages of quarterly values. *Short-term rates:* United States—3-month Treasury bill yield; Japan—Gensaki 3-month rate; West Germany—3-month bill rate; France—3-month government note (pension); United Kingdom—91-day Treasury bill yield; Canada—3-month Treasury bill rate. *Long-term rates:* United States—average yield on government bonds with 30-year maturity; Japan—yield on benchmark 10-year bond; West Germany—yield on most recent issue 10-year bond; France—average yield on 10-year government bonds; United Kingdom—yield on 10-year gilts; Canada—yield on 10-year government bonds.

Source: History—OECD Main Economic Indicators and Shearson Lehman Economics; Forecast—Shearson Lehman Economics.

Senator **Sarbanes**. Thank you very much, gentlemen. I want to express our appreciation for the very thoughtful statements you have submitted, which you summarized in your testimony.

I want to ask a few general questions of the panel, first working from Mr. Fiedler's statement that in a sense suggests that differences in forecasts don't really matter, as I understand the first paragraph of his statement.

I find that troubling. A lot of people spend a lot of time on forecasting and a lot of decisions are made on the basis of forecasts. In fact, in the budget documents my recollection is that a 1 percent difference in the GNP growth rate means about $20 or $25 billion on the deficit figure. So right there you're in a different order of magnitude in addressing the deficit question as it would be perceived by the administration and by a Congress; $20 to $25 billion on the deficit is not an inconsequential figure, given the magnitudes we're dealing with.

The blue chip economic indicators in their statement on the 10th of February said that the consensus estimate for 1987 did slip to a murky growth rate of 2.3 percent. This is a smidgeon under the 2.4 percent average of a month ago, but more than a half a point lower than when 1987 was first projected by our panel in January of last year. The forecast now is nearly a percentage point below the growth rate expected by the Office of Management and Budget.

I guess my first question to the panel is, how important are these forecasts? Isn't a difference of almost a point in expectations significant? Is there a purpose in trying to search this out and arrive at what is regarded as the most reasonable figure?

Mr. **Jasinowski**. Mr. Chairman, if I could start, I would say that our remarks may have been—at least my remarks may have been interpreted as too cavalier with respect to the forecasts.

What I was trying to say was that the long-term trade macro challenges were not going to be primarily determined or affected by the quarter-to-quarter changes in the next couple of quarters.

Having said that, you're quite right to stress that a percentage point difference in GNP growth is going to have a very major effect on the deficit and my own judgment is that in 1987 the Federal budget deficits are going to be substantially larger than the administration is forecasting and that the whole deficit set of problems will be more difficult to achieve.

So certainly with respect to deficit projections, the growth numbers in the forecasts are important.

Mr. **Fiedler**. Mr. Chairman, I got a listing of projections by blue chip and by a variety of others just the other day for the fourth quarter to fourth quarter, and that particular compilation of blue chip was 2.8 percent and they ranged up past the administration's number of 3.2 percent to a high of 3.5 percent.

What I would suggest is that these are all close enough in terms of their general thrust and general direction in which the economy is going, the necessity or not necessity for dealing with shortrun policy stimulus questions, the question of risks in the outlook for inflation, but that they are inconsequential differences in terms of what I regard as the more important issues such as long-term growth and the budget deficit.

Senator **Sarbanes**. Now I want to get at this for a minute. In August of this year, the Council forecast a growth of 4 percent for the latter half of 1986. Now the growth in fact was at 2.3 percent, although it still may have to be adjusted. That's partly preliminary and partly final.

I guess my question is, do you regard that as an insignificant difference?

Mr. **Fieder**. Insignificant for what purpose, sir? What I would respond to you is that a difference of that sort is well within the typical pattern of error by forecasters, that we should not expect based on past performance that forecasters, whether they use econometrics or leading indicators or seat-of-the-pants or whatever, are in fact going to be able to give you a forecasting performance that will in fact hold consistently better than that.

Senator **Sarbanes**. Could I ask the other members of the panel whether they agree that a forecast of 4 percent made in August 1986—in other words, made in the very period you're forecasting—when the actual figure is 2.3—assuming that is the actual figure, put aside this preliminary point—whether that difference is inconsequential and doesn't matter?

Mr. **Sinai**. I would, after being part of the forecasting fraternity for so many years, say that that particular forecast was a larger than typical error. I think I'm speaking for others that are in the forecasting—do it as a profession—I would not want one to have the impression that that is a typical error that forecasters make on real GNP, that particular forecast, done that late at that time.

Now the administration has had in its forecasts, regardless of who the Chairmen were, with the exception of the one forecast when Martin Feldstein was the Chairman, has consistently been very optimistic and upbeat on growth. This year I think their forecast of 3.2 percent for 1987 fourth quarter to fourth quarter is much more plausible, much more realistic than most of the others.

When you get out in the outyears of the forecast, they are really very hard to believe, but they do say that they are planning numbers rather than forecast numbers.

So I do not think, on average, the economic forecasters make the kind of error that showed up in that forecast, but also, users of forecasts should understand and probably do where the forecasts are coming from and what some of the biases may be and make their own adjustment. It is always, I think, wise to look at several forecasts and several different providers of them and sometimes to average them to see what is the tendency and the direction.

On forecasting in general, we would be fooling people if we told them that we could predict single numbers specifically. Our best value in these numbers is planning numbers and to give an idea of directions for trends.

Now when you get to your deficit question, a 1 percent error is certainly significant because it is at least $20 or $25 billion, and if you get less growth and more unemployment you can get more than that. So for budget planning, the budget is very sensitive to those economic assumptions and that's just one of the inherent problems about doing budget work for Congress. I don't think there's any way around it.

Mr. **Hormats**. I'll defer to the expertise of my colleagues on this one. I think they are more experienced in this area than I am.

Mr. **Jasinowski**. The one thing I would add, Mr. Chairman, is that, again, the quarter-to-quarter numbers are not really the critical numbers here.

If you look at what's happened since 1984, we have shifted to a 2 percent growth economy down from a very fast recovery in the early stages of this business cycle. This panel and the economics profession in general tends to suggest and forecast that that 2 percent over the next several years or something somewhat higher, but certainly not rapid growth, is what is going to continue. And I would say that, given that historical pattern since 1984, one ought to notch down the administration's forecast of 3 percent or err on the side of assuming that that forecast is too optimistic.

Mr. **Fiedler**. To finish my thought, Mr. Chairman, I would certainly agree with you and Allen Sinai about the significance of a $20 to $25 billion difference in the size of the budget deficit resulting from a 1 percentage point error in the forecast of real GNP or nominal GNP, either one.

But the point I would like to make is that when we are talking about budget deficits in the range of $200 billion that I believe should be eliminated—not all in 1 year, but we ought to be thinking about the $200 billion, not about the $20 or $25 billion.

Senator **Sarbanes**. Let us assume that's what we're thinking about. How fast would you eliminate the $200 billion deficit? Do you first of all agree that if we were to try to eliminate it too quickly we might provoke the economy into a downturn which would then, instead of moving toward eliminating the deficit, in effect, compound the deficit problem? Do you agree with that?

Mr. **Fiedler**. Yes; you might. The fact that the economy did not go into a superheated boom during the period when this deficit was building up is a reminder that there is no one-to-one relationship between economic performance and fiscal policy stimulus or restraint and, therefore, there is a lot of uncertainty about that kind of relationship and the question is uncertain, but there is certainly the "might" there.

Senator **Sarbanes**. How much of the deficit do you think could be eliminated in the next fiscal year? The Gramm-Rudman target?

Mr. **Fiedler**. $50 to $75 billion. I think that's consistent with Gramm-Rudman off the top of my head, not remembering the precise numbers year to year. But, of course, doing it in a more meaningful fashion than the kinds of budget hijinks that have been so prominent both here in the Congress and in the President's budget recently.

Senator **Sarbanes**. Accepting the goal of reducing the deficit and putting it on a downward-moving trend, I want to ask each panelist whether he sees an independent authority or rationale for the dollar figures used in the Gramm-Rudman bill for what the deficit objective should be. In other words, it sets out certain objectives. It's $108 billion for this year. I think it's $72 billion for the following year, and $36 billion for the year after that, and zero for the year after that.

Now I want to know from each of you whether you think there is an independent rationale for those figures and, if so, what that rationale is?

Mr. **Sinai**. I think those figures were entirely arbitrarily set to define a declining path for the budget deficits over "a reasonable length of time." Those figures I believe now are out of date and the inherent fallacy in the law is that we have had a weak economy that has produced unified budget deficits that are higher than were expected when whose targets were set. Now the calculations of cuts from the current expectations of unified budget deficits have been affected by a weak economy, so the cuts are bigger, and if you hit those fixed targets you drive the economy down more and you will not reduce the deficits by the cuts that are made. So I think that those targets either have to be adjusted or the way in which the calculation cuts are based on have to be changed.

Mr. **Jasinowski**. Mr Chairman, I think that Mr. Sinai's answer is exactly the right answer if the budget deficit is looked at entirely as a macroeconomic instrument and without significant political and national priority aspects.

My own view, though, is that we are looking at a problem which is at least as significantly political and, for that reason, I would say that there is a political logic to the Gramm-Rudman targets and that is the logic of the Congress having worked its will on those targets and that one ought not to throw over those targets based on macroeconomic thinking by itself.

Senator **Sarbanes**. Where are you going to be with that logic if you impose it and help to precipitate a downturn and end up with an even bigger deficit than we now have?

Mr. **Jasinowski**. All I'm saying is that we cannot make this decision on economic grounds alone and that there is nothing that Mr. Sinai or any other macroeconomist can tell you that is so precise about the movement of the economy over the next several quarters and the effect of trying to achieve a $50 billion reduction which we are sure is going to precipitate a downturn.

The whole aspect of the complementarity of monetary policy, the extent to which exchange rates could come down further and trade could pick up some slack are important aspects of this.

I share his concern from an economic point of view and the logic economically is correct. We are not dealing with just an economic problem, though, and if one begins to throw off these targets—and I'm not saying they should not be reconsidered—it is a function of this committee to do so and I think quite appropriately—but to throw those over on economic grounds alone would be a serious mistake.

Senator **Sarbanes**. Mr. Hormats.

Mr. **Hormats**. I would simply say that it strikes me that in this current budget-cutting debate or attempt to cut the budget, one needs some type of target and I would not presume to defend any particular number but it does seem to me that some political striking point—some political target is perhaps necessary in order to drive the political decisions that are going to have to be made in this Congress.

I would also say, however, that getting back to the testimony that all of us have given—that is, we're in an international environment here and how far we can go down with respect to our budget deficit and slow our economy depends in part on other considerations such as exchange rates and heavily in part on what the international economy is going to do. We have a lot more latitude to go down and reduce our own budget deficit if we can expect a somewhat higher rate of growth abroad to absorb some of the costs of that decline. If we do it in isolation, without taking those into account, we may come up with quite different assumptions.

Mr. **Fiedler**. The international offsets that Mr. Hormats refers to is one of a number of offsets. Two is the risk of a downturn being generated by a tightened fiscal policy.

Another is monetary policy to which Allen Sinai referred and the fourth is built into the Gramm-Rudman-Hollings legislation itself, a trigger that releases the targets if and when a recession is forecast—if an increase in unemployment of a certain size is forecast.

So you always have these kinds of risks but you have to keep your powder dry and keep some flexibility in the policy. I don't know any other way that anybody would suggest we handle that kind of problem.

Mr. **Sinai**. Just one more word. I want get back to what I think the flaw in the Gramm-Rudman-Hollings legislation. It is that you have a fixed set of targets. The numbers don't matter so much, but you calculate the cuts based on a budget concept that itself depends on the economy. Any if, for whatever reason, the economy gets worse than one thought, those deficits will be higher. If you take those fixed numbers and you make the subtraction, the cuts you have to make by statute—and I would say Congress really was quite wise not to go all the way last year—is a lot larger than you originally thought. If your economy is weak, you're doing exactly the wrong thing.

Now how do you deal with the problem? You either change the targets or you change the concept on which you make the calculated cuts. I would say that a better concept, though it is imperfect, would be to use the cyclically adjusted budget deficit and to calculate the cuts from that. If those numbers are lower, the cuts would not be as large and one could keep the Gramm-Rudman-Hollings targets that serve as a guidepost for everyone to know that we really do want to get the budget deficits down. I think there are lots of ways to do it, but as its now stands the flaw could be fatal and the trigger mechanism doesn't solve it either because by the time we all learn the economy is doing poorly enough to produce a 1 percent drop the momentum of two or three negative quarters would be built up and then you're going to have those deficits go up, no matter what you do, not going down, and you are at $225 or $250 billion and back with all the same problems that the Congress has been working on now for 3 or 4 years to eliminate.

Senator **Sarbanes**. All right. Let me move to another subject I want to touch on. You have all taken the view that if we can reduce the budget deficit it will make a contribution to the trade deficit question. Is that correct?

Mr. **Hormats**. Yes.

Mr. **Fiedler**. Yes.

Senator **Sarbanes**. All right. At what point do you start looking at what you're doing on macroeconomic policies in terms of its impact on microeconomic policies as they relate to the trade deficit?

To be specific, suppose we were cutting physical infrastructure, education, training, research and development, all in the name of reducing the budget deficit to make a contribution toward reducing the trade deficit, and yet the cuts are being made in programs which we look to make a contribution on the competitiveness front and, therefore, our ability to address the trade deficit.

Mr. **Hormats**. Let me try that one. In the last part of my testimony I tried to focus some attention on just that problem and it does strike me that one can do—there is a great risk here—things in the short term in the interest of some temporary improvement in our trade position which have enormous long-term costs, and I think, Mr. Chairman, you have identified a number of those.

If there is one single determinant of improved competitiveness over the long run, it is the quality of the American system of education. And I think if you look at every country that has done well competitively over the last 20 years, that those countries have placed enormous emphasis on education. In the 1950's and 1960's, Korea was putting lots of money into education. People kept saying, "Why are you doing this? You don't have enough jobs to take the people who come out of your colleges." And they knew what they were doing and they built up a highly educated work force. The same in Japan and West Germany and the same in other parts of East Asia.

And it strikes me that it would be a tragedy of myopia if you were to look at—if by cutting the budget deficit in order to get some short-term gain we were to have long-term costs.

The same is true with research and development. One could make a similar case. The same is true and has been for some time with the Export-Import Bank. I mean, there are some who want to cut the Export-Import Bank. It's very important to a number of industries to improve their competitiveness.

So one has to look at priorities. Sweeping cuts—this is one of the problems I have with the Gramm-Rudman is that sweeping cuts across the board don't make the sorts of distinctions which are of long-term importance and it strikes me that if we're really going to compete effectively—not just today and tomorrow but position ourselves for the next century, we have to look at the fundamentals—sort of the Vince Lombardi school of economics—look at the fundamentals, what are they—and education and research and development have to rank at the very top of that.

Mr. **Jasinowski**. Mr. Chairman, the question you raised is exactly the same dilemma that the corporation trying to become more competitive in today's world faces and what you find is that you can make very substantial cuts in costs to begin with because you can find redundancies and things that you didn't do well. But after you've done that, you have to invest in order to be more competitive. You can't simply cut and cut and cut and increase competitiveness infinitum.

So I think you're absolutely right to stress the fact that we must invest as well and in my prepared statement we indicate the importance of education, research and development, and innovation, and a number of other areas that require attention if we're going to be more competitive over the long term.

It is a mistake to believe that the competitiveness problem is so much a macro problem that we don't look at those. It's a long-term productivity and efficiency problem as well and that's going to require some investment.

Senator **Sarbanes**. Just let me say on that, I didn't quite understand in your statement, Jerry, why, in addressing the trade deficit and the trade policy, it's all that important to separate out what the percentage terms are coming from each factor. It seems to me all the factors are relevant and if we have a comprehensive trade strategy we should be addressing all of them—the budget deficit, the overvaluation of the dollar, regulation, education, research and development, physical infrastructure, so forth and so on. They are all pieces of a puzzle and to have a sensible policy it seems to me you have to address all of them since none of them is an inconsequential piece of the puzzle.

Mr. **Jasinowski**. You're quite right, Mr. Chairman, and in my prepared statement I've laid out 12 points which are fairly comprehensive.

I think the reason for stressing the macro is to distinguish between the short-term gains and the long-term gains. I don't think anyone can argue that improvements in education are going to help in the very short run on trade, whereas improvements in reducing the budget deficit and exchange rates can have fairly short-term improvements on trade.

Remember, the trade deficit went from about $40 billion in 1982 to $107 billion by 1986, and if there was one thing I would stress over and over and over again it is that we have a 3-year escalation in the trade deficit that can only be explained by macroeconomic factors which in the short run is where we can make the greatest gains. But over the long term, after exchange rate and other things have been dealt with, the more important aspects are going to be education systems, innovation, corporate competitiveness, and all those other things. And that's no reason why we shouldn't address them right now; it's just distinguishing between the payoffs short and long term.

Senator **Sarbanes**. Let me ask anyone who wants to respond what his view is of the correlation between the strength of various national economies and the assumption of international responsibilities for the movement of the world economy the countries seem prepared to make.

The thrust of my point is essentially that the United States continues to assume or have thrust upon it a very heavy responsibility at a time when its economy no longer has the same dominant position as in earlier years, and that countries whose economies now have become very strong, relatively speaking—Japan and West Germany—are still operating on the old premises and not assuming responsibilities for the international economy that it is reasonable to call upon them to assume.

Mr. **Hormats**. I think there has been for sometime and remains today a lag in the degree to which the international influence on economic issues or on economies has changed and the sort of political and security responsibilities which should logically go along with that. The problem here is the United States today is a debtor country which still has responsibilities that it inherited from a point in time when it was by far the world's dominant creditor and by far the world's dominant economy. Those are security responsibilities, foreign assistance responsibilities, responsibilities for maintaining a trading system, a whole array of things; whereas you have had a big shift in world economic influences your question implies, with Japan and Germany and other Western European countries being major players in the world economy today, but there's been a lag in the public awareness or in the Government awareness in a number of those countries of the need to assume these broader security and economic responsibilities.

An example is the United States is held to a certain rather unique discipline in the area of trade. People say, "You're the dominant actor in the world economy. If you do something in trade it can affect the world economy. We're smaller economies; we can get away with things that don't affect the world economy, so don't trouble us."

The same is true in the area of security. There has been a sort of general understanding that remains today that the United States will take the lion's share of responsibility for maintaining the security of the free world. That's not just military expenditures; that's foreign aid and it's intelligence expenditures and a whole array of things. And gradually, over a period of time, if we're going to maintain a better equilibrium in the economic area, we also must have somewhat better equilibrium in these other areas.

For instance, more countries doing more to support the Latin American debtors—and this is a political and economic and a security issue. The conventional view around the world is, well, it's in your backyard, the United States, you deal with these problems; and by and large we have.

Japan recently has put more money into both Brazil and Mexico, but it seems to me a general understanding of how to share the overall burden, particularly involving more support from the big capital-exporting countries, would be a step in the right direction.

Mr. **Fiedler.** I agree with Bob Hormat's point there completely. Our share of the total pie has declined. There are two points that offset that. One is that the United States in the financial world is still dominant and the other is that in the trading world, while we're no longer dominant in the sense of being more than 50 percent of the total among the largest industrial countries, we are still something like 40 percent and so we're still the single biggest player.

But clearly, the decline to which you and Bob Hormats referred to is something that ought to be taken into account by us and others.

Mr. **Sinai.** The Economic Report was a good report and they had a number of issues that touched on the budget and competitiveness that are very critical, but they did not talk much about policies of economic cooperation and coordination, either between monetary and fiscal policy here in the United States or between the policies of our trading partners and ourselves. And, I would add to it even the newly emerging countries as well. And I think as these problems get more complicated, the solutions to them or making progress on them requires a somewhat different size of attack.

I'll give you an example. Can Congress go ahead and cut the budget deficit, which is absolutely necessary, without knowing what the Federal Reserve will do? You can guess what the Federal Reserve will do, but it would be nice to have some idea that there would be some offsetting compensating ease to pick up the slack that you and I worry about if we move toward budget balance. But then, there would be an effect on the exchange rate as well. Can we tighten our budget without our trading partners picking their growth rates up through some stimulus if you think of the whole world economy?

Well, these are just simple illustrations. I think the whole issue of policy coordination and collaboration is a new one, not touched on in the CEA report, and is going to become increasingly important. Already, the inability to get our policy mix right in the last 4 or 5 years has given us tremendous problems today and I submit that this is a new area for the JEC and others to get into.

These problems are too complicated for any one branch or any one country to deal with by itself.

Senator **Sarbanes**. I think that's an interesting perspective. For instance, Germany and Japan are being pressed to expand their internal economies. The figures I have seen is that for the U.S. trade deficit, the most that might mean is perhaps $10 billion. It seems to me that they ought to be being pressed very hard to recirculate the surpluses they are accumulating to help address the Third World debt question. We have a proposal that would create a special facility under the IMF or World Bank to address that question, primarily funded by the countries that are now running very large current account surpluses. Some way to get assured resumption of growth in the developing world would make a much more significant difference to the U.S. trade deficit as a matter of fact than greater growth internally in Japan and West Germany.

It seems to me reasonable now to say to these countries that they have to start playing this role. First of all, they are not carrying a major defense burden. It's 1 percent of GNP in Japan and roughly 3.5 percent in West Germany. Above and beyond that, of course, is the strength of their economies—and their own interests in a growing international economy and a fairly orderly world economy.

We need to be pressing that point. The shifts in the trade figures with Latin America, when you look at the U.S. trade imbalance, are really very significant. A fairly large proportion of it has come from there.

Mr. **Jasinowski**. Mr. Chairman, if I could just follow up and reinforce what you and others have said with two basically political points. One, our discussions with European and Japanese leaders in the business community and government indicate that during the last cycle, to some extent, they were laughing at us as we proceeded to take on the burden of getting the whole world economy growing again at the expense of greatly raising our budget deficit. The Germans in particular thought, "It's amazing what you're doing for us. You leave the market open. You stimulate the world economy. And we'll just continue to sell you Mercedes Benz."

So I think that they privately not only agree with you, but they would go even further than they do publicly.

The second political point is that if there's one thing that the American manufacturing community feels about government, it is that they have tended—in the international area—to be naive with respect to dealing with the kind of challenges we must face.

At the NAM, we have consistently opposed protectionist legislation and will continue to do so, but there's a whole realm of areas where we can exert strong views about how others need to share in these burdens and how trade policies should be changed without getting into anything having to do with protectionism.

Senator **Sarbanes**. Let me address one final question to the panel. You have been very generous with your time and we appreciate it. My question goes to the word "protectionism," and I want to get some sense of people's definition of it.

If one has the perception—and assume for the moment the perception is accurate—that the rules under which trading is taking place are not fair and reciprocal, would you label steps taken to address that problem as protectionist?

Mr. **Hormats**. I think it, in part, depends on what they are. This is a traditional issue. When I was Deputy USTR I know I had to deal with this on a weekly basis, and that is, to what degree do you lose credibility internationally in terms of getting more access to foreign markets if you completely eliminate or exclude the option of taking measures which from time to time limit imports of other countries into our economy?

Senator **Sarbanes**. Let me sharpen the question. There is a widespread perception in the Congress that our competitors have an advantage over us because their access to our market is easier and more open than our access to their markets, and that many countries are working lots of angles, as it were, to take advantage of current trading arrangements in a way that does not go to the fundamental question of the cost and quality of the goods. They are doing lots of other things that enable them to affect the movements and so forth unrelated to the fundamental questions of cost and quality.

Is that an inaccurate perception?

Mr. **Hormats**. I think there's a lot of logic to that argument. There are two ways of looking at this. One, we have a very open economy and not only that, our whole industrial structure is based and our consumer structure is based on companies going around the world and seeking items and pulling them into our economy to retail them—and components from around the world—to make our final goods less expensive. And other countries simply don't look at the world economy in quite that way. They don't have the same very elaborate retailing structure that pulls in a lot of these goods.

The other point I would make is generally that we have traditionally seen ourselves as a very open economy and other countries have, in the rebuilding effort after the war, husbanded their resources and developed their own domestic economic structures sometimes with a rather porcupinish attitude toward foreign products.

That's really a legacy of 40 years of different philosophies—different approaches.

I would make one point, though, and it shows up in this CEA report. That is that the focus of what we are doing, using such things as section 301 of the Trade Act, to identify the sort of restrictions that you have talked about across the board—on services, goods, investment, a whole range of things—is a way which is not going to lead to immediate results but over a period of time at least we have in our legislation a procedure for dealing with that type of issue.

And it seems to me we should continue to exercise our legitimate interests there and use that sort of technique because I think the problem is one that's real. Unless we are able to get real progress in opening up and dealing with the sort of impediments which you've talked about, then it's going to be much harder to maintain the sort of open economy which I suspect a lot of people would still like to see us maintain.

Mr. **Jasinowski**. Mr. Chairman, I would distinguish between market access in other countries on the one hand and protection from imports in this country on the other. If you take the market access question, whether or not we're looking at Japan in telecommunications or Brazil and computers or any other market access question, it's very hard for the United States to take actions which are so strong that they can conventionally be labeled as protectionist. We are not protecting. We are trying to open up markets.

So I would just stress the value of the U.S. Government looking at market access opening aggressively as a major way to deal with leveling the playing field.

Senator **Sarbanes**. What about taking an approach that requires the trading partner to look at the problem of opening up market access with the understanding that failure to do so would mean that their access to our market was going to be limited or restrained? We would hold out the prospect of doing that and might in fact do it, but we would not assume the burden of opening up their markets. That burden, in a sense, would be theirs. You would say, "Look, we have an enormous trade imbalance. We think there are lots of things happening that just are not fair competition, but we're having trouble figuring out what they are. You're pretty good at that, and you know a lot better than we do what they are, and every time we deal with one of them then half a dozen more emerge." So we're taking, in a sense, an easy way from our point of view. We do know one thing we can do and do rather effectively, and that is control the entry into our markets. We are not out to do that, but to prevent our doing it, you have to do something with your markets.

Mr. **Jasinowski**. Well, I think as a negotiating position you couldn't have stated it better. I sense that where you're taking the discussion though is toward the Gephart-Bentsen amendments to the trade bill last year where you have Federal automatic imposition of quotas if market access is not achieved.

We oppose that, although we are certainly looking carefully at that whole idea of using leverage because of its automatic and consequently I think heavy-handed way of trying to deal with that. I do think that that's the area where more thought needs to be given. I think when you begin imposing quotas automatically though as a part of Federal legislation, you reduce substantially the flexibility that we would have by using the same technique vigorously in negotiations. Maybe the others would want to comment on that.

Senator SARBANES. It would seem to me that the manufacturers would be screaming about three things that have happened in economic policy. One is that we have approached the Third World debt problem, at least prior to the Baker initiative in Seoul—and even that I think is not adequate—by imposing austerity on the developing countries, so that they would be able to pay their debts—that is, meet the obligations to the financial institutions. This put a heavy burden on manufacturers and I think there was, in effect, a direct conflict. I think our policy ought to be better than that so we don't have what amounts to a conflict between the condition of our financial institutions and what's happening to our producers.

Second, we had an overvalued dollar for a very sustained period of time. By some estimates we confronted a 30-percent discount when we were trying to compete and I don't see how anyone could compete.

Third, I don't think we've been tough enough on the trade terms. I think we've operated on the old premise about the U.S. economy and entry into it and I think, again, our producers have paid a heavy price for that.

Mr. JASINOWSKI. Well, I think you're right and, therefore, our concern about Gephart does not mean that we do not want to move in the general direction of market access and, beyond that, I think to just finish my statement on the import side is the whole question of protecting intellectual property rights, improving the antidumping laws, bringing up both the law and the enforcement of the law so that it is equal to what other countries are doing, and there's substantial room for us to be tougher.

Where I would draw the line is on the imposition, again going back to your question on protectionism—the imposition in a crude fashion of automatic quotas that come down and close off the flow of trade. I think that's where you get into a very clear indication of protectionism.

Senator SARBANES. Do you think we will be able to prompt other countries to do what I think reasonable people would agree they should do on the trade front, if there is not implicit in the prodding the possibility that their entry into our market is going to be affected?

Mr. JASINOWSKI. I don't really know the answer to that, Mr. Chairman. I think you've gone now to the very heart of the question that we will be looking at over the next couple years. My judgment would be that we need to try a more flexible get-tough policy before we proceed a next step and see the response of our trading partners. We still do set the tone for world trade in negotiations and if we do not get a response at that point, then we squeeze the screw a bit tighter but do so in a carefully calculated way so as not to disrupt world trade.

Mr. HORMATS. If I could add one point to that, I think Jerry's answer was a good one. I would say that it is possible, because in fact the administration has made some progress in a number of areas in the last couple of years with respect to particular sectors. I would say, however, that there are times when you need to toughen up a position if reasonable negotiations don't achieve reasonable solutions.

The one area that I am concerned about and has been proposed as sort of a legislative remedy is that there should be some sort of mandatory requirement, the President should have no discretion at all with respect to what to do if progress isn't achieved with respect to particular sectoral negotiation. And I would say that, while one should toughen up the position, that there should be enough latitude for the President, as President of the United States, to exercise a certain measure of discretion as to what the penalty is or what the remedy is if the negotiations don't go forward.

It's a tough balance and I was in front of the Senate Finance Committee a couple of weeks ago and I was testifying with Alan Greenspan on this very question, and a number of members put it—it's a delicate balance. How do you make yourself credible without at the same time putting yourself totally into a legislative straitjacket? That's a very difficult balance to figure out.

Mr. **Fiedler**. I had one more question or response to your perception or the congressional perception you mentioned that other countries are taking advantage of us in this trading business.

It seems to me there's a distinction to be drawn here between an economywide result and an industry-by-industry result because for lots of reasons, including the fact that the trade is almost always valued in U.S. dollars, why on an economywide basis all of that taking advantage is on our side. That is, we are getting the break. We are being subsidized. We are getting goods in here cheaper and paying off with cheaper dollars, if you will, so that we get an advantage from an economywide standpoint.

But when you look at it industry by industry and the ping-pong ball industry of country *x* is therefore taking advantage of the U.S. ping-pong ball industry, I think the answer is yes, there is a disadvantage. There is a loss on an industry basis and in that sense, that it seems to me, when it's done in extreme at least, is something that ought to be corrected and utilizing the kind of strategic patterns that you referred to is not unwarranted at all as long as we end up going in the direction of a freer and more open trading system rather than the other way around.

Senator **Sarbanes**. Let me ask you on the economywide basis because it's an interesting point you make, and I have often wondered about it—I haven't wondered too much, actually, because I think I have a response. In effect that's saying, "Look, if countries want to dump, to sell us their product at 50 percent of what it costs them to produce it, why not let them?" That's terrific. They are, in effect, giving us a substantial subsidy on this product and we're getting it cheap. What's wrong with that? Why don't we let them pour it in here?

As I look at them, my reaction is that there's the short run and the long run. That's fine in the short run, but what it means—and not very far in the long run—is that American jobs disappear one right after the other, and it's not too long before we're in no position to buy those goods, no matter what rate they're being dumped into the country.

So it seems to me that even economywide there's a problem with it. It simply can't be sustained. There's not an underlying economic rationale to sustain those practices even looking at them economywide, although it's true you do get a kind of benefit in the very short run.

Mr. **Fiedler**. I agree with your distinction of short run versus long run, but I do not see any situation where the subsidy goes on for such a long time that—nobody wants to give away its natural resources and its work effort permanently so that there is a lack of incentive on the side of the other countries to do that.

But your point is well taken to the extent that we do not want that to be done extremely in specific industries because we will get ourselves into a position where we are somehow dependent and then the other country gets a monopoly.

Senator **Sarbanes**. I would go further than that. I don't see how you could tolerate it to begin with, because if you do, I don't know what the rules are that govern the international trading arrangement. In other words, if you're going to accept dumping as a practice, then what are the rules of the game by which everyone is supposed to play? Then each country can try to maneuver the system to its particular advantage.

Mr. **Sinai**. I think the sentiment of Congress is frankly, right on. Our trading partners have made their livelihood for years through their trade. Japan has lived by exports so they are going to concentrate very hard on that and drive their economy by that. And since it has not been as important for us, we haven't paid that much attention to it.

But the sentiment that you described I would say is exactly right on. The trade problem is not just a macro event. It's the competitive strategy of our trading partners. It's also our own inattention I would say to our own productivity and the quality of what we do. We simply have to work harder and make our products better and the dollar isn't going to bail us out of that. The free trade stance that we have taken, while appropriate in theory for economists like us to take, has just been an umbrella, I believe, for our trading partners because we have stuck to this free trade stance.

Now is protectionism good or bad? I would say it's bad in theory as it runs the risk of retaliatory action and you go down a road you don't want to go down in terms of interrupting trade flows and inflation, depending on the kind of measures taken. But the threat of it and some use of it, I would say, in practice is a good thing and our bargaining power is just what you described—it's that our markets are large and that we buy so much from abroad that it is tremendous bargaining power and we are foolish not to use it in a stronger way in negotiations with our trading partners.

I, like my other colleagues here, would stop short of taking away discretion and forcing mandatory changes on tariffs and quotas against a somehow deemed unfair trading practice. It's a little hard to define that and leave the executive without anything to say.

I may be wrong in my interpretation of some of the legislation making its rounds through Congress, but I think that's a different issue. But the issue of getting tougher on trade with countries—and I would include the NIC's—we are losing out because they will not let their currencies float freely and so we now have only 53 percent of our merchandise trade deficit with the five countries where the dollar goes down. We will not get much leverage with that. We have to get them to open their markets and to let their currencies float as well.

So I would tend to be very sympathetic with the kind of sentiments that you have expressed. Trade is too important to us now. It's the tail now wagging the dog.

Mr. **Fiedler**. It's the whole hindquarters.

Senator **Sarbanes**. Well, thank you, gentlemen, very much. It's been a very good panel. We appreciate your contribution.

Rabbi Saperstein, would you please come forward. We are prepared to hear from you now. Go right ahead.

STATEMENT OF RABBI DAVID SAPERSTEIN, MEMBER, BOARD OF DIRECTORS, NATIONAL COMMITTEE FOR FULL EMPLOYMENT, ACCOMPANIED BY CALVIN H. GEORGE, EXECUTIVE DIRECTOR

Rabbi **Saperstein**. Mr. Chairman, my name is Rabbi David Saperstein. I am please to appear here today on behalf of the National Committee for Full Employment and its sister organization, the Full Employment Action Council, and to offer our views on the Nation's struggle to achieve a full employment economy.

These are broad-based coalitions comprised of national labor, civil rights, religious, public interest, urban, and farm groups. I am accompanied today by Calvin George, who is the executive director of both these organizations.

We are pleased to release today to members of the committee and the public at large a NCFE special report entitled "Jobs '87: The Moral and Ethical Challenge of Joblessness and Underemployment," which both reviews recent social policy statements by leading American religious organizations on employment related issues and examines the performance of the American economy in meeting these challenges. My testimony will present the highlights of this report and further explore and make recommendations on alternative public policy solutions.

With your permission, I would like to abridge my testimony and ask that the full testimony and the more detailed "Jobs '87" report that we released today be entered into the record.

Senator **Sarbanes**. Without objection, so ordered.

Rabbi **Saperstein**. Mr. Chairman, the vast majority of America's religious organizations, denominations and faith groups have, for many years, been unified in recognizing the essential nature of work within our society and the moral implications of high rates of unemployment and underemployment. They have spoken out forcefully about the injustice of a society that discards workers with little or no thought given to questions of stewardship and the waste of human resources.

The critical nature of employment is reflected in the wide range of church documents which address this issue. The Catholic bishops' pastoral letter on the economy and its call for full employment is merely one representative expression of the abiding concern of the religious community on this issue. Many denominations and faith groups have joined the call for a fully employed society, including Baptists, Congregationalists, Episcopalians, Jews, Lutherans, Presbyterians, Unitarian Universalists, United Methodists, and others, along with the National Council of Churches.

You have asked us, Mr. Chairman, to evaluate the policies of the administration and indicate where we think those policies will take the American economy in 1987 and the years beyond.

It is seems to me there is a fundamental difference in the vision we have of American society and the role of the Government in that society. The administration seems to believe that there is an inherent justice working in the marketplace and the microeconomic institutions of America, and government intervention, even when done for the best of purposes, inevitably causes more harm than it achieves good.

We have a radically different notion; one that has been standing within the mainstream of American history for the past 50 years: those institutions will be affected by power in such a way as to ill serve the needs of the vast majority of Americans; and it is not only the right, but the indispensible responsibility of government to intervene in such a manner as to make America a more fair, a more compassionate society; to intervene on behalf of those who cannot speak out for themselves—the neediest.

And what is at stake in this difference is the entire vision of active and compassionate government, a full partner in achieving decency and justice for the most vulnerable Americans. What is at stake is the loss of a vision expressed by Ralph Waldo Emerson, who said: "The true test of American civilization is not the census nor the profits nor the state of its cities, but the kind of people that this nation produces."

All of our organizations share a moral tradition that compels us to stand with the poor and the oppressed. We must confront the moral power the policies of our government are today neglecting; abusing the weakest and most vulnerable members of our society, including the children, the elderly and the homeless. The administration may promise a safety net for the truly needy, but we know that between the promise and the deed is an aching abyss filled with the shattered lives of millions of our brothers and sisters; the elderly trapped on fixed incomes, the stymied victims of racism and sexism, the handicapped facing obstacles at every turn, the mother with the sick child in her arms standing in a hospital door closed to her, the lost legion of minority who are out of school, out of jobs, out of hope, filled with anger, frustration, and despair—all of these in danger of being recycled into a permanent underclass that makes a mockery of our pretensions of fairness and justice. We believe that the way to break that cycle is in the words of Miamonedes, perhaps the greatest of all Jewish scholars of the past two millennium, "to help people to help themselves," by giving them a job, by giving them the opportunity to provide for themselves.

The truth is that the problems of unemployment or underemployment have not greatly improved. There has been some slight improvement in the 1986 over 1985 levels, but the unemployment rate hovers at a historically high level of 7 percent in 1986. This is a level of unemployment 20 percent greater than the rate of 4.8 percent achieved in 1979 and nearly double the amount that most economists feel is a base systemic unemployment rate in what we could classify as a full employment economy.

The Bureau of Labor Statistics' Commissioner Norwood testified a few days ago that the unemployment rate in January 1987, 50 months into the current recovery, is a full percentage point higher than the 50 months into the recovery from the 1973-75 recession. And the official unemployment rate is an incomplete indicator of underemployment in the economy.

The National Committee for Full Employment calculates a real rate of joblessness and underemployment by including measures of people working part time but who are seeking full-time work, and of those who want work but are too discouraged to search. This fuller measure of joblessness and underemployment also fell slightly between 1985 and 1986 from 12.9 to 12.6 percent, but remains 39 percent higher in 1986 than its 1979 level of 9.7 percent.

This means that in 1986, 50 million Americans were unemployed or underemployed on average in each month, with over 1.1 million discouraged workers having fallen out of the job search market and 5.6 million stuck in part-time work.

We are here today to ask, above all, that these not remain inanimate statistics. Each figure represents one human being, and behind each person are others, tens of millions, whole families and communities who suffer the cost of this deprivation.

We ask you to look at the cost of continued excessive rates of unemployment in human terms: in broken families, in broken hearts and broken homes, in mortgage foreclosures, welfare dependency, higher crime rates and other forms of social dysfunction.

Unemployment results in heightened community tensions and a loss of confidence in the American democratic system. America cannot afford these economic and moral costs.

Now hidden in these statistics are seven other alarming economic trends that we believe are frequently overlooked.

First is the fact that the burden of such hardships remains systemically unequally distributed. The black community remains disproportionately unemployed. Since 1979, however, the groups experiencing the largest increases in joblessness have been whites and Hispanics, but all this has done is to bring those groups closer to the disastrously high rates of joblessness that exist in the black community rather than ameliorating unemployment among blacks. Equality should not be achieved by bringing us to the lowest common denominator.

Second, the current administration boasts about the millions of new jobs created since 1980, but a more careful examination reveals laggard progress. In point of fact, the rate of job creation during the last 6 years has actually been less than during any administration since Eisenhower and at only 80 percent of the job creation pace under the Carter administration.

Third, in 1986, 5.6 million people, or approximately 5.1 percent of the labor force, were trapped involuntarily in part-time work. Though somewhat smaller than the 5.2 percent share of the work force in 1985, this is a large increase over the 3.4 percent of the work force similarly trapped in 1979 and represents virtually the same absolute number of individuals affected.

Fourth, the average wages of nonsupervisory workers have suffered. The shifts in employment from 1979 to 1985 created a 3.5-percent reduction in average weekly wages, an amount equal to each worker suffering in $11.50 weekly cut in pay or a $600 annual loss.

Fifth, displaced workers comprise one-fourth to one-third of all adult unemployment. This dislocation creates long-term joblessness, as nearly half of dislocated workers experience more than 6 months of joblessness. When those who have lost their jobs do eventually find work, it is almost always at lower pay—a 15 percent average reduction in weekly pay. Dislocated workers who are forced to find work in new occupations or industries take new jobs at wages 25 to 30 percent below their previous earnings.

Sixth, the problem of obtaining adequate income is demonstrated in the deterioration of family income, which fell 4 percent from 1979 to 1985 despite the fact that more people were working in the average family.

Finally, seventh, the shrinking of the middle class is a sign that far fewer Americans are able to sustain a mid-level income despite working harder. Census statistics show that there were nearly 4 percent fewer families with $15,000 to $50,000 incomes in 1985 than in 1979. This shrinkage of the middle class meant there was 2.4 million less middle class families in 1985 or 7.7 million individuals less in the middle class, than there were in 1979.

Mr. Chairman, these problems demand attention. The administration argues that economic growth can be the primary solution to these problems, but we know that economic growth alone is simply not enough under the realities we face. For 50 years in America the Government has been an indispensible component in meeting the microeconomic needs of this nation in providing jobs for people. There have been increased efforts to stimulate jobs on the whole that have worked, but as Congressman Augustus Hawkins, one of the chief authors of the 1978 Full Employment and Balanced Growth Act, which was the culmination of this 50 years of government effort to help simulate employment opportunities in America, recently concluded, "Economic policymaking is in shambles. Two administrations, Democratic and Republican, have merely made forecasts of what may happen to the GNP, unemployment, and economic growth rates, and other economic indicators. But since the passage of the Act, we have yet to see an economic report from the President, a Federal Reserve Board report, or a Joint Economic Committee report that constructs the actual programmatic means for achieving 4 percent unemployment."

Mr. Chairman, this course of events must be changed. The 100th Congress can choose to be a truly historic Congress, and the Joint Economic Committee, under your leadership, can help to chart the course for this and future Congresses. The time is now. Much of the energy for the newly emerging "American Competitiveness" theme comes from the average American person's desire and hope that they will find increased job opportunities, income security and real improvement in their standard of living, and that their aspirations to qualify for the jobs of the future will be met in reality. This theme, however, can be hollow and short lived if it does not lead to bold and decisive action that people can see in their everyday lives. The Humphrey-Hawkins mandate for reordering national priorities should lead to a careful cost-benefit analysis of current spending, and a resolve to eliminate the unnecessary and wasteful costs of excessive joblessness, underemployment, the long-term burdens associated with massive trade deficits, and dependency on government transfer payments by those of our brothers and sisters who are able and willing to work. On this front, the Congressional Budget Office's most recent estimates are that for each 1 percentage point of excess unemployment, the Federal Treasury loses, depending on how one measures it, up to $44 billion in lost revenue and expenditures for unemployment compensation, food stamps, and other transfer payments.

Mr. Chairman, I know that you and the committee are well aware of many of these problems, and that your staff has done much to document the jobs and income crisis facing the Nation. We urge you to continue these efforts and hope that out of this work and these deliberations will come the articulation of a new agenda for the Nation. We would call it, if you will, a Quality of Work Life Agenda or a Jobs 2,000 Agenda that combines a range of approaches and creates a unified vision for high quality job growth, worker adjustment and investment in human resources, but an agenda that will settle for nothing less than moving this nation in a direction of achieving the goals of a full employment economy. The National Committee for Full Employment, in consultation with its member organizations and several prominent economists, is currently at work developing the details of such an agenda, and will share its version with you when it is completed later this spring.

But in the interim, there are several areas in which we believe that this session of the 100th Congress can and must take action. The highest items on this agenda include:

Creation of a nationwide worker readjustment and retraining system, including mandatory prenotification of plant closings and permanent layoffs, just compensation, and transition assistance in such cases;

An increased minimum wage indexed to inflation and bringing workers and their families above the poverty level;

Creation of a humane and effective welfare-to-work transition program that builds on the positive elements of the WIN program and provides incentives and leadership through the Federal-State-local JTPA system, in partnership with the private sector, to assist welfare recipients in achieving economic self-sufficiency; and

Finally, perhaps the most indispensible in the long run, the expanded investments in our nation's young people, in giving them the skills they need to be competitors in the job market of the future. This is particularly necessary for minorities who will make up one-third of our entry level work force by the 1990's, but are most ignored by our current economic and educational institutions and must have summer jobs linked to year-round remediation and dropout prevention efforts.

Mr. Chairman, thank you for the opportunity to address this committee today and we will be glad to answer whatever questions you have.

[The prepared statement of Rabbi Saperstein, together with the report referred to for the record, follows:]

PREPARED STATEMENT OF RABBI DAVID SAPERSTEIN

Mr. Chairman and distinguished Members of the Joint Economic Committee, my name is Rabbi David Saperstein. I am pleased to appear here today on behalf of the National Committee for Full Employment (NCFE) and its sister organization the Full Employment Action Council (FEAC), and to offer our views on the nation's struggle to achieve a full employment economy. I am accompanied today by Calvin George, NCFE and FEAC Executive Director. We are pleased to release today to Members of the Committee and the public at large a NCFE Special Report entitled JOBS '87: The Moral and Ethical Challenge of Joblessness and Underemployment, which both reviews recent social policy statements by leading American religious organizations on employment related issues and examines the performance of the American economy in meeting these challenges. My testimony will present the highlights of this report and further explore and make recommendations on alternative public policy solutions.

Mr. Chairman, various religious organizations, denominations and faith groups have for many years recognized the essential nature of work within our society and the moral implications of high rates of unemployment and underemployment. They have spoken out forcefully about the injustice of a society that discards workers with little or no thought given to the questions of stewardship involved and the waste of human resources. The critical nature of employment is reflected in the wide range of church documents which address the issue.

Work must be seen as not only a necessity for the individual but also as a right, to be provided for in times of unemployment and underemployment by whatever means available.

The Catholic Bishops Pastoral Letter on the economy and its call for full employment is representative of the abiding concern of the religious community on this issue. Many denominations and faith groups have joined the call for a fully employed society including Baptists, Congregationalists, Episcopalians, Jews, Lutherans, Presbyterians, Unitarian Universalists, United Methodists, and others, along with the National Council of Churches.

Unemployment and Underemployment

Though slightly improved over 1985 levels, the official unemployment rate has remained at the historically high level of 7.0 percent in 1986. This is a level of unemployment 20 percent greater than the rate of 5.8 percent achieved in 1979, when we were at a similar point in the sustained recovery from the 1973-75 recession, as we are now in the 1983-87 economic upturn. As BLS Commissioner Norwood testified on February 6, 1987, the unemployment rate in January, 1987, 50 months into the current recovery, is a full percentage point higher than that 50 months into the recovery from the 1973-75 recession."

The official unemployment rate is an incomplete indicator of underemployment in the economy. The National Committee for Full Employment calculates a "Real Rate of Joblessness and Underemployment" by including measures of people working part-time but who are wanting full-time work and of those who want work but are too discouraged to search. This fuller measure of joblessness and underemployment also fell slightly between 1985 and 1986, from 12.9 percent to 12.6 percent, but remained 30 percent higher in 1986 than its 1979 level of 9.7%. In 1986 15 million Americans were unemployed or underemployed on average in each month, with over 1.1 million discouraged workers and 5.6 million stuck in part-time work.

We are here to ask, above all, that these not remain inanimate statistics. Each figure represents one human being. And behind each person are others; tens of millions -- families and communities who suffer the costs of such deprivation. We ask you to look at the costs of continued excessive rates of unemployment in human terms -- in broken families, mortgage foreclosures, welfare dependency, higher crime rates, and other forms of social dysfunction. Unemployment results in heightened community tensions and a loss of confidence in the American democratic system. America cannot afford these economic and moral costs.

Hidden in the statistics are seven other alarming trends that frequently are overlooked. First, the burden of such hardships is not distributed equally. The black community remains disproportionately unemployed. Since 1979, however, the groups experiencing the largest increases in joblessness have been whites and Hispanics, bringing each group closer to the disastrously high rates of joblessness in the black community, rather than ameliorating unemployment among blacks. Equality should not be achieved by bringing us to the lowest common denominator.

Second, the current Administration may boast about the millions of new jobs created since 1980 but a more careful examination reveals laggard progress. The rate of job creation during the last six years has actually been less than during any Administration since Eisenhower and at only 80 percent of the job creation pace under the Carter Administration.

Third, in 1986, 5.6 million people, or approximately 5.1 percent of the labor force, were trapped involuntarily in part-time work. Though somewhat smaller than the 5.2 percent share of the work force in 1985, this is a large increase over the 3.4 percent of the workforce similarly trapped in 1979 and represents virtually the same absolute number of individuals affected.

Fourth, the average wages of nonsupervisory workers have suffered, as was demonstrated in the recent Industrial Union Department publication, "The Polarization of America: The Loss of Good Jobs, Falling Incomes & Rising Inequality." The shifts in employment from 1979 to 1985 created a 3.5 percent reduction in average weekly wages, an amount equal to each worker suffering an $11.50 weekly cut in pay or a $600 annual loss.

Fifth, displaced workers comprise one-fourth to one-third of all adult unemployment. This dislocation creates long term joblessness, as nearly half of dislocated workers experience more than 6 months of joblessness. When those who have lost their jobs do eventually find work, it is almost always at lower pay - a 15 percent average reduction in weekly pay. Dislocated workers who are forced to find work in new occupations or industries take new jobs at wages 25-30 percent below their previous earnings.

Sixth, the problem of obtaining adequate income is demonstrated in the deterioration of family income, which fell 4 percent from 1979 to 1985 despite the fact that more people were working in the average family.

Seventh, the shrinking of the middle class is a sign that far fewer Americans are able to sustain a mid-level income despite working harder. Census statistics show that there were nearly 4 percent fewer families with $15,000 to $50,000 incomes in 1985 than in 1979. This shrinkage of the middle class meant there was 2.4 million less middle class familiesin 1985 or 7.7 million individuals.

Mr. Chairman, these problems demand attention.

Economic growth in itself, especially at the levels of recent years, has been insufficient to either bring down the overall unemployment rate or reduce the enormous inequities that fall disproportionately on minorities, blue collar workers in changing industries, youth, women (especially single heads of households), and others isolated in our inner cities and depressed farm communities. Rapid technological change, declines in competitiveness on world markets and in our own domestic market, and an over-reliance on monetary policy to manage the economy coupled with a broad retreat from investments in human resource development and basic research, are all contributing to the inadequacy of employment and earning opportunities described in this report. High levels of joblessness and underemployment are no longer confined to low points in the business cycle.

Rather, the nature of unemployment, economic recovery and stable (though slow) growth no longer means factories adding back the second and third shifts or farmers making new investments in equipment and machinery. As the problems change, so must our solutions. Retreat from social and economic development programs and policies are no solution at all.

The federal government began its assault on joblessness during the Great Depression of the 1930's with the creation of various labor market institutions like the Employment Service and protections for workers with the unemployment insurance system and the minimum wage. Concern for making the transition to a peacetime economy immediately after World War II brought the Employment Act of 1946 and the first stabs at coordinating economic policy and planning through the creation of the Congressional Joint Economic Committee and the President's Council of Economic Advisors.

The Civil Rights movement took off in the mid-50's and led in the 1960's to the nation's reaffirmation of equal justice for all and rejection of "poverty in the midst of affluence." As labor market institutions and social programs were again expanded in the 1960's it became clear that these interventions had to also be coordinated with the government's overall economic policy.

The Full Employment and Balanced Growth Act of 1978 (a.k.a. Humphrey-Hawkins) amended and strengthened the 1946 Act by setting quantitative goals and providing a framework for removing disparities in unemployment rates between minorities, youth, women and others in relation to the overall labor force. This Act also had sections dealing with reordering national priorities, controlling inflation,and bringing the Federal Reserve Board into the economic decision-making and goal-setting process.

As Congressman Augustus Hawkins (one of the chief authors of the 1978 Act) has concluded recently, however, "Economic policy making is in a shambles . . . Two administrations (Democratic and Republican) have merely made forecasts of what may happen to the GNP, unemployment and economic growth rates, and other economic indicators. Since passage of the act, we have yet to see an economic report from the president, a Federal Reserve Board report, or a Joint Economic Committee report that constructs the actual programmatic means for achieving 4% unemployment."

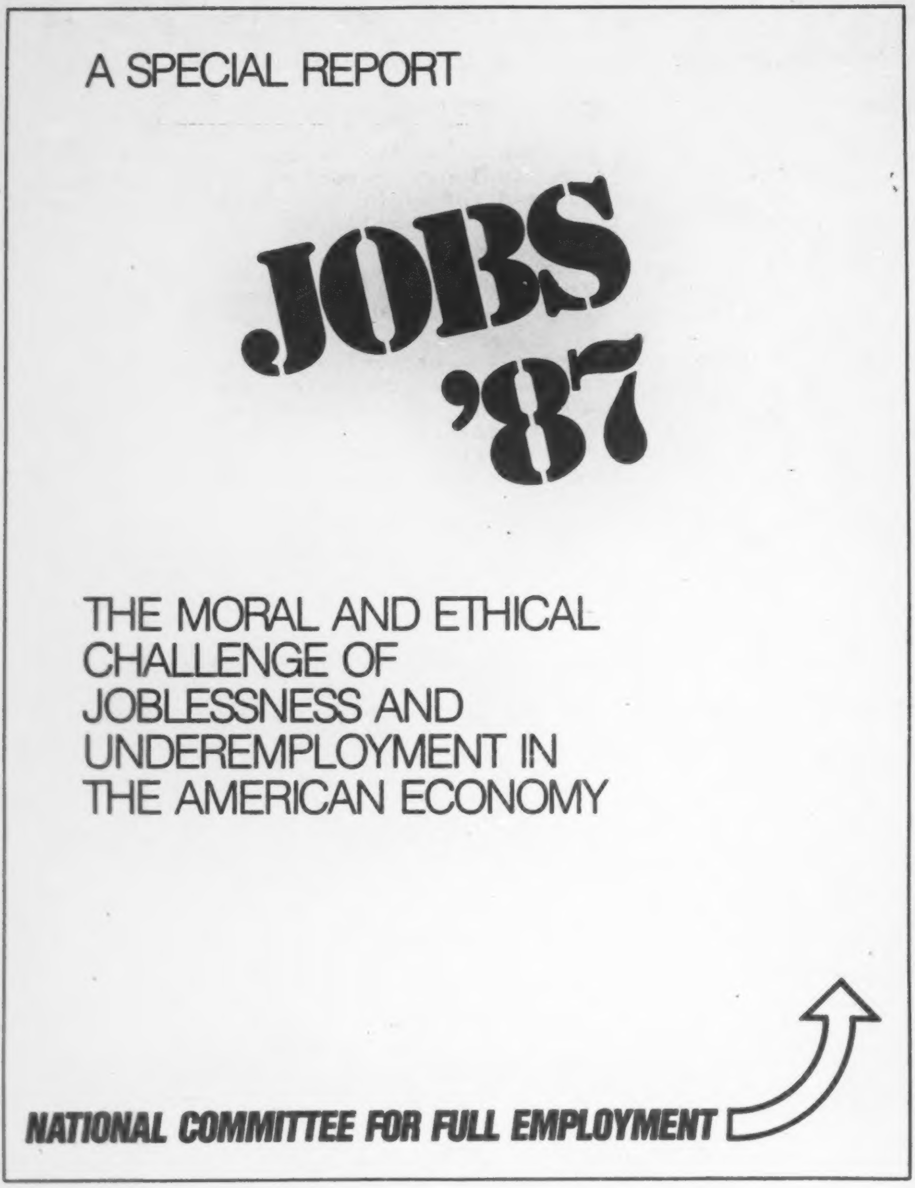
Mr. Chairman, this course of events must be changed. The 100th Congress can choose to be a truly historic Congress, and the Joint Economic Committee, under your leadership, can help to chart the course for this and future Congresses. The time is now. Much of the energy for the newly emerging "American Competitiveness" theme comes from people's concern with the need for increased job opportunities, income security and real improvement in their standard of living, and their aspirations to qualify for the jobs of the future. This theme, however, can be hollow and short lived if it does not lead to bold and decisive action that people can see in their everyday lives. The Humphrey-Hawkins mandate for reordering national priorities should lead to a careful cost-benefit analysis of current spending and a resolve to eliminate the unnecessary and wasteful costs of excessive joblessness and underemployment and the long term burdens associated with massive trade deficits and dependency on government transfer payments by those able and willing to work. On this front, the Congressional Budget Office's most recent estimates are that for one percentage point of excess unemployment, the federal treasury loses $4.4 billion in lost revenue and expenditures for unemployment compensation, food stamps and other transfer payments.

Mr. Chairman, I know that you and the Committee are well aware of many of these problems and that your staff has done much to document the jobs and income crisis facing the nation. We urge you to continue these efforts and hope that out of this work and these deliberations will come the articulation of a new agenda for the nation. We would call it, if you will, a Quality of Work Life Agenda or a Jobs 2000 Agenda that combines a range of approaches and creates a unified vision for high quality job growth, worker adjustment and investment in human resources. The National Committee for Full Employment in consultation with its member organizations and several economists is currently at work on developing such an agenda and will share its version with you when it is completed later this Spring.

In the interim, there are several areas in which we believe that this session of the 100th Congress can take action. The highest items on this agenda include:

- creation of a nationwide worker readjustment and retraining system, including mandatory pre-notification of plant closings and permanent lay-offs, just compensation, and transition assistance;
- an increased minimum wage indexed to inflation and bringing workers and their families above the poverty level; and
- creation of a humane and effective welfare-to-work transition program that builds on the positive elements of the WIN program and provides incentives and leadership through the federal-state-local JTPA system (in partnership with the private sector) to assist welfare recipients achieve economic self-sufficiency;
- expanded investments in our nation's young people (particularly minorities who will make up one-third of our entry level work force by the 1990's), with summer jobs programs linked to year round remediation and drop-out prevention efforts.

Thank you, Mr. Chairman, for hearing our testimony today. We would be glad to answer any questions you or other Members of the Committee might have.



A SPECIAL REPORT

JOBS '87

THE MORAL AND ETHICAL CHALLENGE OF JOBLESSNESS AND UNDEREMPLOYMENT IN THE AMERICAN ECONOMY

NATIONAL COMMITTEE FOR FULL EMPLOYMENT

NATIONAL COMMITTEE FOR FULL EMPLOYMENT

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United Steelworkers of America
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National Council of LaRaza

The National Committee for Full Employment (NCFE) and the Full Employment Action Council (FEAC) speak for a broad coalition of labor, religious, civil rights, women's, business and other community groups that support a national commitment to full employment. NCFE conducts research, policy development, and educational activities. FEAC organizes legislative initiatives, mobilizes political support, and stimulates debate on employment issues during election campaigns. Together, NCFE and FEAC seek to build broad public support for the proposition that this nation can and must commit its resources not just to the rhetoric of full employment but to the fact.

This report is issued by the National Committee for Full Employment and the Full Employment Action Council in conjunction with AFL-CIO Amalgamated Clothing and Textile Workers Union • American Federation of State, County, and Municipal Employees • American Jewish Congress • American Youth Work Center • Americans for Democratic Action • Center for Community Change • Children's Defense Fund • Coalition on Human Needs • Coalition of Labor Union Women • Communications Workers of America • Food and Allied Service Trades Department, AFL-CIO • Friends Committee on National Legislation • Human Environment Center • Industrial Union Department, AFL-CIO • Interfaith Action for Economic Justice • International Union of Operating Engineers • Lutheran Council U.S.A. Office of Governmental Affairs • National Congress for Community Economic Development • National Conference of Catholic Charities • National Council of La Raza • National Office for Black Catholics • National Puerto Rican Forum • National Urban League • NETWORK • Presbyterian Church U.S.A. • Rural Coalition • Union of American Hebrew Congregations • United Auto Workers • United Church of Christ, Office for Church in Society • United Food and Commercial Workers • United Methodist Church Department of Social and Economic Justice – General Board of Church and Society • United Mine Workers of America • United States Catholic Conference • United States Student Association • United Steelworkers of America • Youth Service America • YWCA of the USA, National Board • Wider Opportunities for Women • Workers Defense League, Inc.

JOBS '87:

The Moral and Ethical Challenge
of
Joblessness and Underemployment
in the
American Economy

A Special Report of

The National Committee
for full Employment

Murray H. Finley and
Coretta Scott King, Co-Chairs

Calvin H. George, Executive Director

February 12, 1987

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INTRODUCTION

The United States is one of the most economically powerful nations the world has ever seen. We have developed in a short period of time an economy that provides an unprecedented standard of living for most of our people. Unfortunately most is not all. Far too many people have been left out. Too many people have been told, in effect, "you don't count, you have no productive contribution to make". As a nation we must ask how this condition squares with the values that we profess and claim to uphold.

America's commitment to the individual implicitly recognizes the dignity of every human person. As in our civil and political decisions, each economic decision, policy, and institution must be measured against its impact on the dignity of the human person.

From our earliest documents as a nation we have recognized that human rights are the minimum conditions for life in community. These rights not only include civil and political rights (life and liberty), but also implied economic rights. All people have a right to the basic necessities of life such as food and housing.

Deeply ingrained in the American experience is the strong belief that all who are able to work are obligated to do so. This is how the basic necessities are normally distributed. This duty to work is part of what it means to be human. It is necessary for the good of the family, the community, and the nation. Because work is so important, employment must be recognized as a basic human right. It is a right that protects everyone's freedom to participate in the economic life of the community.

We must take seriously the commitment of the Employment Act of 1946 to provide "useful employment opportunities for all those able, willing, and seeking work." Our nation, our economy is rich enough, and should be just enough, to reject as intolerable the current conditions of all too many of our farms, our towns, our industries, and our cities. Unemployment that persists despite economic growth is substantial. Since World War II, it has been drifting upward. No economy can be considered healthy when so many people are denied jobs by forces outside of their control. Our economy is now too abundant for the unemployment, poverty and deprivation still afflicting tens of millions of our people to be explained mainly by personal characteristics of the victims. While many individuals have personal problems that influence their economic condition, a far greater number suffer as a result of deficiencies in national policies and programs.

Overcoming these deficiencies will require co-operation on all levels of society: individuals and communities; labor unions and businesses; government at all levels and voluntary organizations. The federal government has a pivotal role to play. It alone represents all the people. Its policies and programs exert the single most powerful influence upon economic and social performance.

Fundamentally, the most urgent priority of our nation is to create new jobs with adequate pay and decent working conditions. We must end the human and social devastation that joblessness brings to our nation. To protect the basic right to a decent job for all Americans, we, as a nation, must renew our commitment to full employment.

The first section of this report reviews the moral and ethical values enunciated by the nation's leading religious organizations. These values lay much of the groundwork for our major democratic institutions and establish the benchmarks by which we should measure how well they function for individuals and groups of individuals in our society. Our economy and the opportunities it offers are a product of complex and often tangled sets of public and private sector decisions, some of which appear at odds with each other. The public's perception of the economy's health or lack of it is too often based on over-simplified statistical indicators -- the unemployment rate, interest rates, the rate of inflation, the Dow Jones Stock Average. Policy makers and academics sometimes grapple with more complex and less well understood indicators of society's performance, from changes in the Gross National Product (GNP) and rates of productivity to trade balances and currency exchange rates. In each case, analysts risk losing sight of the human dimensions of the numbers and the underlying values; changes of magnitude or incidence acquire over time new thresholds of tolerance and we become numb to their impact on people.

~~The second section of this report examines and dissects~~

The second section of this report examines and dissects recent trends on the statistical indicator front. What does a 7% unemployment rate for 1986 mean? How does it compare with other periods in our economic history? What kinds of new jobs is our economy creating for new entrants to the labor force and for those who are being displaced from old line industries? How much do these jobs pay? What about people who are working part time but want full time jobs? Or those who have given up their active job search and are not included in the official unemployment rate? Is the official unemployment rate an adequate measure of how well individuals are able to function in our complex economic system?

Finally, the report identifies major gaps in our public and private sector policy responses and recommends a series of new and expanded initiatives to both strengthen basic labor market institutions and expand economic opportunities for all Americans.

II. AN INTER-FAITH CONSENSUS ON THE NEED FOR MORE EFFECTIVE EMPLOYMENT POLICY

Proper management of our nation requires that no resource be wasted, whether that resource be land, water, timber, or other natural elements. We are stewards not only for ourselves and our own time, but also for the generations of tomorrow.

Perhaps the most tragic resource to misuse and waste, however, is our human resource -- the human mind, the human spirit, the human muscle, the ability to think, love, relate, as well as the ability to work.

Work holds within it the essence of who we are and what we can become. In large part we are identified by the work we perform, whether it be in the factory, on the assembly line, in the home or in the office. Work is an essential part of the human experience, and a precious resource for us to protect.

Recent interest in the Pastoral Letter on Catholic Social Teaching and the U.S. Economy, "Economic Justice for All," has focused considerable attention on work, and issues related to employment and unemployment. This document states that

> "Basic justice demands that people be assured a minimum level of participation in the economy. It is wrong for a person or group to be excluded unfairly or to be unable to participate or contribute to the economy. For example, people who are both able and willing, but cannot get a job are deprived of the participation that is so vital to human development. For, it is through employment that most individuals and families meet their material needs, exercise their talents, and have an opportunity to contribute to the larger community." ("Economic Justice For All", page x.)

The Bishop's Pastoral Letter, realizing the reality of present day life in the U.S., laments the fact that we have a long way to go to achieve the basic justice mentioned above.

> "Several areas of U.S. economic life demand specific attention. Unemployment is the most basic. Despite the large number of new jobs the U.S. economy has generated in the past decade, approximately 8 million people seeking work in the country are unable to find it, and many more are so discouraged they have stopped looking. Over the past two decades the nation has come to tolerate an increasing level of unemployment. The 6 to 7 percent rate deemed acceptable today would have been intolerable twenty years ago." ("Economic Justice For All", pages 7, 8.)

Various religious organizations, denominations and faith groups have for many years recognized the essential quality of work within our society and the moral implications of high rates of unemployment, or underemployment. They have spoken out about the injustice of a society that discards its workers with little or no thought given to the questions of stewardship involved and the waste of human resources. The critical nature of employment is reflected in a wide range of other church documents, including this Lutheran Church in America statement:

> "Work, the expending of effort for productive ends, is a God-given means by which human creatures exercise dominion. Through work, persons together are enabled to perpetuate life and to enhance its quality. By work they are both privileged and obligated to reflect the Creator whose work they are." (Lutheran Church in America, "Economic Justice," adopted by the Tenth Biennial Convention, 1980.)

Employment: A Human Right

Work is seen as not only a necessity for the individual, but also as a right, to be provided in times of unemployment and underemployment by whatever means available. Both affirming and drawing on the affirmations of the state, the United Church of Christ statement entitled "The Right To Earn A Living" concludes that

> WHEREAS, Our nation's affirmation of the creator-endowed inalienable rights of life, liberty, and the pursuit of happiness are virtually denied to persons excluded from gainful employment, and equality of opportunity becomes meaningless where jobs are not available, there be it
>
> RESOLVED, That the Eleventh General Synod of the United Church of Christ reaffirm the God-given right of all persons to useful and remunerative work, together with the responsibility to provide for themselves and their dependents, and that it therefore also do the following:
>
> 1. Call on all Americans to recognize this right and this responsibility and to reflect on their meaning and implications for the future of the family, neighborhood, city, countryside and nation.
> 2. Call on the federal, state, and local governments together with industry, business, labor and the unemployed to formulate and implement policies and programs to achieve full employment . . . (United Church of Christ, "The Right To Earn A Living", 1977)

Many denomination and faith groups have joined the call for a fully employed society. The Catholic Bishop's Pastoral Letter on Economic Justice states: "We call for a new national commitment to full employment." (page xii.) The Unitarian Universalist Association General Assembly statement on "Poverty and Unemployment" concluded with the RESOLVE "That this Assembly endorses the principle that every person has an inherent and moral right to work at a meaningful wage, food, clothing and shelter." (Poverty and Unemployment, 1985.)

In addition, the Executive Council of the Episcopal Church has issued the following statement on equal and full employment: "BE IT RESOLVED, That the Executive Council call upon Episcopalians throughout our nation to urge policymakers on the local and federal level to focus their efforts on the development of programs, both private and public which offer meaningful employment opportunities to all who wish and are able to work . . ." (Social Policy of the Episcopal Church, 1977, Executive Council.) The 116th General Assembly of the Presbyterian Church, U.S. in 1976 called upon members of its denomination to "support the goal of full employment and to support passage of legislation directed toward this goal." And in 1976 the General Conference of the United Methodist Church issued a statement entitled "Unemployment" calling for ". . . governmental policies . . . that would ensure full employment in order that workers may fully participate in society with dignity, so that families may be economically secure,and so that the nation may achieve coherent high priority goals."

The Importance of Government Response

But there are many in our society who, while not questioning the need for programs designed to put people to work, fear the costs involved either through local, state or federal government programs. Currently our federal deficit inhibits serious discussion of new initiatives whether they be on the health front, the farm crisis, or the problems of unemployment. We are reminded in the following statement, however, that we must also count the costs of continued excessive rates of unemployment and underemployment. The "Resolution of Employment Programs" adopted by the American Jewish Congress Executive Committee states that:

> The social costs of mass idleness cannot be measured in economic statistics alone. They must also be measured in broken families, broken hearts, and broken hope. They are reflected in heightened community tensions. They are the source of loss of confidence in our democratic system. America cannot afford these costs.

In reference to an effective response to unemployment through governmental programs, the statement continues

> Questions are being raised about the cost of these programs and its impact on inflation, recession and our tax system. These are important questions but they must not stand in the way of immediate action on the jobs front. Properly designed and implemented, jobs programs can soon start paying for themselves as they strengthen the economy and produce increased governmental revenues. ("Resolution on Employment Programs," American Jewish Congress, Executive Committee, 1982.)

Church and synagogue statements have also addressed specific facets of the unemployment crisis currently facing our nation. The plight of the worker whose job is literally "here today and gone tomorrow" through the unilateral actions of employers, large or small, is the focus of "Response to Growing Economic Dislocation" by the United Presbyterian Church U.S.A.:

> The United States of America is experiencing a deepening economic crisis marked by plant closings, work force reductions, and layoffs that threaten to become permanent; whole industries are moving from one U.S. region to another and often abroad, with accompanying community disruptions. The current severe economic dislocations are a result of the basic shift in the U.S. economy from a

> manufacturing, industrialized society to a system based on service industries and communication and management of capital. ("Response to Growing Economic Dislocation", 1982.)

Again, in 1983, the Presbyterian Church U.S. addressed the increasing problem of economic dislocation by encouraging "federal and state policies that support and help mitigate the effects on the unemployed by:

> a. Affirming legislation on job creation, full employment, home mortgage foreclosure relief, health insurance, plant closure warning legislation . . ." ("Economic Dislocation," General Assembly, 1983.)

In a statement on "Full Employment", which endorsed the then pending Humphrey-Hawkins Equal Opportunity and Full Employment Act, the Union of American Hebrew Congregations states that "Unemployment in American life now reaches catastrophic proportions . . ." In the year this was issued, 1977, the national unemployment rate was 7.1 percent. The official rate today continues to hover around 7 percent; the catastrophe continues.

The Inequity of American Joblessness

The cruel pattern of unemployment in our society strikes some groups harder than others. Rates are disproportionately high for Hispanic workers, young people, blacks, and women who are the sole supporters of their families. The Catholic Bishop's letter proclaims: "Unemployment is a tragedy no matter whom it strikes, but the tragedy is compounded by the unequal and unfair way it is distributed in our society." (page 8.) A statement issued by the American Baptist Churches underscores this fact.

> Unemployment has not affected all segments of our society equally. It has hit the young, the minorities and blue collar workers especially hard. While many feel their hope lies in the return of a stronger economy, unemployment levels after a recession have never fallen to pre-recession levels. For many, especially older blue collar industrial workers, their jobs are lost forever as factories have either permanently closed or scaled down their work forces.

The statement continues in pointing out that in recent years federal government policies have demonstrated a continuing lack of concern for the unemployed in our society, merely exacerbating the pain caused by joblessness:

> At the same time need has increased dramatically, the programs which would assist those who are hurt are being scaled back. In 1975 two-thirds of the unemployed received benefits while in 1982 only 40% did. [That figure dropped below 30% in 1986.] When unemployment benefits run out, many do not qualify for public assistance. They become eligible only when they have divested themselves of everything but a house, an old car and $1,500 worth of possessions such as savings accounts, household furnishings and even burial plots. By the end of 1982, 10.7 million people were without health care coverage because of job loss. ("Resolution on Unemployment in the Eighties, American Baptist Churches, 1983.)

While the concern is real, many in the religious community are realizing that church and synagogue organizations need assistance from every sector of society to address the causes and alleviate the pain of unemployment. In its Book of Resolutions, the United Methodist Church encourages cooperation with "private business and labor to create the jobs needed to secure employment for all who wish to work." The statement continues by calling upon those in its denomination to

> "Encourage and support local, state, regional, and national coalitions that constructively address private and public sector policies that related to the issues of unemployment and underemployment, plant closings and economic dislocations, and other ancillary concerns." (Book of Resolutions, United Methodist Church, 1984.)

* * * *

From a diversity of religious traditions, a clear consensus exists on the need for a full employment economy and an active government role in achieving that goal. As long ago as 1958 a pronouncement of the National Council of Churches of Christ General Board perceived the dilemma in a manner which is, unfortunately, as true today as it was 29 years ago: "The deepest tragedy of unemployment is that work ceases for millions when there is so much work to be done."

II. MEASURING THE ECONOMY'S RESPONSE TO THE FULL EMPLOYMENT CHALLENGE

Labor market developments in 1986 provided only slight improvements in employment and income for American workers. Every indicator of labor market health shows that the American worker's situation has deteriorated since 1979, the last cyclical peak and the last full non-recession year before the 1981-82 recession. Unemployment is high, real wages have fallen, and underemployment has expanded. The driving forces behind this deterioration are the rapid expansion of low wage industries in the service sector, depressed import sensitive industries and an unbalanced macroeconomy. This labor market deterioration has lead to increased poverty and a shrinking middle class.

These labor market developments are most clearly seen by comparing 1986 labor market conditions to those of 1985 and 1979, as is done below for unemployment, wages and job creation.

Unemployment and Underemployment

Though slightly improved over 1985 levels, unemployment remained at the historically high level of 7.0 percent in 1986 (See Table 1). This is a level of unemployment 20 percent greater than the rate of 5.8 percent achieved in 1979, when we were at a similar point in the sustained recovery from the 1973-75 recession, as we are now in the 1983-87 economic upturn. As BLS Commissioner Norwood testified on February 6, 1986, the unemployment rate in January, 1987, 50 months into the current recovery is a full percentage point higher than that 50 months into the recovery from the 1973-75 recession. This is especially troublesome since every major demographic trend -- less youth entering the labor force, the elimination of the male/female unemployment gap -- indicates we should have a lower rate now.

TABLE 1: The Jobs Deficit

	1986 (000)	1985 (000)	1979 (000)
Unemployed	8,327	8,312	6,137
Discouraged Workers	1,122	1,204	771
Part-Time for Economic Reasons	5,588	5,590	3,373
Total Affected	14,947	15,106	10,208
Real Rate of Joblessness and Underemployment	12.6%	12.9%	9.7%
Official Unemployment Rate	7.0%	7.2%	5.8%

The official unemployment rate is an incomplete indicator of underemployment in the economy. The National Committee for Full Employment calculates a real rate of joblessness and underemployment (Table 2) by including measures of people working part-time but wanting full-time work and of those wanting work but who are too discouraged to search. This fuller measure of underemployment also fell slightly between 1985 and 1986, from 12.9 percent to 12.6 percent, but remained 30 percent higher than its 1979 level of 9.7%. In 1986 15 million Americans were unemployed or underemployed on average in each month, with over 1.1 million discouraged workers and 5.6 million stuck in part-time work.

TABLE 2: Real Rates of Joblessness and Underemployment by Population Group

	1986	1985	1979
Total	12.6%	12.9%	9.7%
Whites	11.1	11.2	8.7
Blacks	22.8	24.3	18.9
Hispanics	18.6	18.3	13.6
White Teens	25.3	21.6	21.3
Black Teens	52.6	48.8	47.2
Female Family Heads	18.3	--	--

The burden of unemployment is not distributed equally. The black community remains disproportionately unemployed. Since 1979, however, the groups experiencing the largest increases in joblessness have been whites and Hispanics, bringing each group closer to the disastrously high rates of joblessness in the black community, rather than ameliorating unemployment among blacks.

Another disturbing trend is the worsening underemployment of our youth, which rose nearly 4 percentage points for both black and white teens in 1986. This is despite a shrinking teenage population and a rapidly deteriorating real minimum wage.

While there is now more unemployment, there is also harsher unemployment. Duration or length of unemployment, as measured by the Bureau of Labor Statistics (BLS), was 40 percent longer in 1986 than in 1979, although slightly improved over 1985. Moreover, more than one-fourth of the unemployed were out of work at least 15 weeks and one out of seven were jobless for at least half a year. (Table 3) There is more long-term joblessness in America today.

TABLE 3: Length of Unemployment

			% Unemployed More Than:	
	Mean	Median	15 Weeks	27 Weeks
1986	15.0	6.9	27.1	14.4
1985	15.6	6.8	27.7	15.4
1979	10.8	5.4	20.2	8.7

Adding to this severity is the fact that cutbacks in unemployment compensation have left a very high percentage of the unemployed without any benefits, as studies by the congressional Joint Economic Committee have shown. In recent years, less than one-third of the unemployed have received benefits. Unemployment is severe enough in terms of stress, illness, self-doubt and deteriorated family life without adding to the financial burden by allowing unemployed workers to fall through the safety net.

Job Creation

The problems that working Americans face are not only the prospects of protracted joblessness but also a deterioration in the type of jobs which are available. This is demonstrated by the extraordinarily high numbers of people working part-time but wanting full-time work, and the fact that the majority of new jobs are low-paid.

The current Administration may boast about the millions of new jobs created since 1980 but a a more careful examination reveals laggard progress. The rate of job creation during the last six years has actually been less than during any Administration since Eisenhower, and at only 80 percent of the job creation pace under the Carter Administration. This, to be fair, can be partially explained by slower population growth. Nevertheless, the increase in labor force participation experienced in the 1980's -- the percentage of the population choosing to work -- is much slower than the increases in the 1970's. So, by any reasonable standard, the current Administration's performance is substandard. It has an inferior record both in the number and quality of jobs being created and in creating conditions that increase labor force participation rates, particularly among minority youth.

As goods- producing jobs fall and nearly all job growth is in the service producing sector job growth is becoming increasingly unbalanced. (Table 4) Examining the service sector, it can be seen that it is the lowest paying industries within the service sector that account for most of the growth. From 1979 to 1985, three-fourths of the 9.5 million jobs created in the expanding sectors were in retail trade and the service industries, the two lowest paying industries and those with the highest proportions of part-time work. In 1986, these two industry groups provided 61 percent of the job growth. What is occurring is the relative contraction of the highest paidsectors in the economy, both in and out of the service producing sector. Transportation, communications, utilities and government -- the highest paying service sector jobs -- are all experiencing below average growth. At the same time, there has been an absolute loss of nearly 2 million jobs in manufacturing and mining.

TABLE 4: Job Creation/Loss by Sector*

	1979-85	1985-86	
	Gain/Loss	Gain/Loss	Share of Growth
Total Non-Agricultural	7,791	2,554	100.0%
Goods Producing	-1,531	10	0.4%
Mining	-29	-137	--
Construction	224	274	10.7%
Manufacturing	-1,726	-127	--
Service Producing	9,321	2,544	99.6%
Transportation, Communication & Utilities	106	43	1.7%
Wholesale	536	113	4.4%
Retail	2,371	616	24.1%
Finance, Insurance and Real Estate	978	351	13.7%
Services	4,862	1,099	43.0%
Government	468	323	12.6%

* Based on Total Employment data from BLS establishment surveys.

This unbalanced growth is creating a surplus of part-time work and lower wages. In 1986, approximately 5.1 percent of the labor force, numbering 5.6 million people, was trapped involuntarily in part-time work. Though somewhat smaller than the 5.2

percent share of the work force in 1985, this is a large increase over the 3.4 percent of the workforce similarly trapped in 1979 and represents virtually the same absolute number of individuals affected. (See Table 5) This increase means that an additional 1.9 million people were working part-time involuntarily in 1986.

TABLE 5: Wages of Lost and Gained Jobs

	Usual Weekly Earnings*	Jobs (thousands)
Average Job	$325.85	--
Average Jobs Lost **	$444.30	2,347
Average Jobs Gained **	$272.39	9,187

---

* For Private Sector production workers in 1979, inflated to 1985 dollars.

** Weighted average pay of the two digit industries in which jobs were lost or gained between 1979 and 1985.

The average wages of nonsupervisory workers have suffered as a result. This was demonstrated in the recent Industrial Union Department publication, The Polarization of America: The Loss of Good Jobs, Falling Incomes & Rising Inequality. The shifts in employment from 1979 to 1985 created a 3.5 percent reduction in average weekly wages, an amount equal to each worker suffering an $11.50 weekly cut in pay or a $600 annual loss.

The actual burden falls on those coming into the workforce who can no longer find good jobs. (Table 5) The industries in which jobs were gained paid only $272 weekly, an amount 16 percent below the average wage and 40 percent below the weekly wages of $444 paid in industries that are losing jobs. This means there is a 40 percent pay gap between those industries gaining and those losing jobs.

Earnings

The earnings workers received failed to improve in 1986, an astonishing fact in a recovery year, even though productivity increased by a modest 1.1 percent. (Table 6) As a result, real wages remain much lower than wages in 1979.

TABLE 6: Nonsupervisory Worker Earnings ($ 1986)

	Average Hourly Earnings	Average Weekly Earnings	Average Weekly Hours
1986	$8.76	$304.85	34.8
1985	$8.73	$304.88	34.9
1979	$9.31	$332.20	35.7
		Changes	
85-86	0.3%	0.0%	-0.3%
79-86	-6.3%	-8.2%	-2.5%

This decline is worth reviewing in detail. As Table 6 shows, the real weekly earnings of nonsupervisory workers in 1986 was the same as in 1985. This left real weekly earnings in 1986 over 8 percent less than in 1979, a situation caused by fewer hours of work per week (2.5 percent less) and lower hourly earnings (6.3 percent). So, despite four years of recovery, American workers have not seen their wages return to pre-1981-82 levels. In fact, since real wages fell 1.4 percent in 1985 and failed to rise in 1986, we can see that the last two years of the recovery have not brought any wage improvements.

The fact that the buying power of wages did not rise in 1986 is astonishing for another reason -- our extremely low inflation rate. Prices rose only 1.9 percent in 1986, an extraordinarily low rate created by the nearly 40-50 percent drop in energy prices last year. Prices other than energy rose 3.9 percent last year, providing even a sharper contrast to the flatness of the earning curve.

These figures complement what we know from Census Bureau compilations of workers' annual earnings up through 1985. (Table 7) Annual earnings for males, working full-time year round, has been falling since 1973. Full-time, year round women's earnings have risen in the last six years, about 3.7 percent. The annual earnings of all (male and female) full-time, full year workers was less in 1985 than in 1979. The fact that weekly earnings stagnated in 1986 leaves little hope that annual earnings in 1986 (available in August, 1987) were able to return to 1979 levels.

The current Administration sometimes takes refuge in pointing out that total compensation (wages and fringes) have been rising faster than wages alone, a factor caused by higher fringe benefit increases. It turns out, however, that real compensation per hour in 1986 was still below its peak level achieved in 1978 and that much of the increase is due to rising payroll taxes and not factors raising a worker's standard of living.

TABLE 7: Annual Earning Trends

	Full Time/Full Year ($ 1985)			
	Male		Female	
	Median	Mean	Median	Mean
1985	$24,195	$27,414	$15,624	$17,028
1979	25,252	28,310	15,065	16,113
1973	27,085	29,308	15,339	16,128
	% Changes			
73-85	-10.7%	-6.5%	+1.9%	+5.6%
79-85	- 4.2	-3.2	+3.7	+5.7
73-79	- 6.7	-3.4	-1.8	-0.1

	All Workers ($ 1985)			
	Male		Female	
	Median	Mean	Median	Mean
1985	$17,779	$21,113	$ 9,328	$11,109
1979	19,284	21,976	8,876	10,077
1973	20,937	22,731	7,845	9,542
	% Changes			
73-85	-15.1%	-7.1%	+18.9%	+16.4%
79-85	- 7.8	-3.9	+ 5.1	+10.2
73-79	- 7.9	-3.3	+13.1	+ 5.6

Source: Census Bureau P-60 Series

Job Quality

There has been much recent debate about the nature of the jobs being created. It has already been shown that a large share of jobs created (25 percent) has been part-time jobs; jobs that have been filled by people wanting full-time work. These new jobs have also been created in the lowest paid industries.

Studies have shown, however, that some new jobs are in higher-paying occupations. Nevertheless, the combined result of all of these factors is that the majority of new jobs are low paid. A recent JEC study by economists Barry Bluestone and Ben Harrison further illustrates this point.

TABLE 8: Quality of New Jobs

Pay Level	Share of Wage and Salary Jobs 1979	~~1985~~ 1984	Share of Job Growth, 1979-1984
High	16.5%	14.9%	-5.5%
Middle	53.1	52.7	47.5
Low	30.4	32.4	58.0

~~Source: McMahon and Tschetter, "The Declining Middle Class: A Further Analysis," Monthly Labor Review (September 1986).~~

The above computations show that the percentage of middle income jobs has fallen since 1973 as the share of lower paying jobs has risen. From 1979 to 1984, the majority of new jobs have been low paying jobs, accounting for 58 percent of the new full-time wage and salary jobs created during this period. With job growth again centered in low wage industries in 1986, and with real wages stagnant, it is overwhelmingly clear that this situation did not improve last year.

Worker Dislocation

Increasing attention is being paid to the problem of worker dislocation, -- workers, who because of plant closings or permanent lay-offs, lose their jobs. Worker dislocation is organically linked to the other problems which have been reviewed. Displaced workers comprise one-fourth to one-third of all adult unemployment. Moreover, it is the exceedingly high rate of job loss which has created our higher levels of unemployment now versus the 1970's. Increased "job loser" unemployment (as opposed to unemployment from new entrants or workers quitting jobs or reentering the workforce) accounts for two-thirds of the rise in unemployment from 1979 to 1985.

High levels of dislocation are the result of the large decline in goods production and manufacturing jobs, including many jobs eliminated by plant closings. This dislocation creates long term joblessness. Nearly half of dislocated workers experience more than 6 months of joblessness. When those who have lost their jobs eventually find work, it is almost always at lower pay. On average, workers suffer a 15 percent reduction in weekly pay. Dislocated workers who are forced to find work in new occupations or industries, take new jobs at wages 25-30 percent below their previous earnings.

Family Incomes, Poverty and the Middle Class

The fundamental concern of government economic policy should be what is happening to the standard of living of all Americans. The primary determinant of most people's income is what they earn from the jobs they have. This includes having access to year-round jobs; that is, avoiding unemployment and earning a decent wage on the job. With higher unemployment and lower wages it is clear that most people are experiencing problems obtaining adequate incomes. The reduction of government support to low income Americans exacerbates the problem for those at the bottom of the economic ladder.

The problem of obtaining an adequate income is demonstrated in the deterioration of family income, which fell 4 percent from 1979 to 1985 despite the fact that more people were working in the average family. At the same time, the percentage of people with income below the poverty level rose from 11.7 percent in 1979 to 14.0 percent in 1985,a rise of 20 percent. Over 33 million Americans were living in families that had poverty incomes in 1985. Again, sustained high unemployment and wage trends suggest there was probably little improvement in 1986.

Another dimension of the problem is the shrinking middle class, a sign that far fewer Americans are able to sustain a mid-level income despite working harder. This shrinkage has been identified in numerous studies. Census statistics show that there were nearly 4 percent fewer families with $15,000 to $50,000 incomes in 1985 than in 1979. This shrinkage of the middle class meant there was 2.4 million less middle class families in 1985 or 7.7 million individuals.

These problems demand attention.

III. THE POLICY MORASS

Economic growth in itself, especially at the levels of recent years, has been insufficient to either bring down the overall unemployment rate or reduce the enormous inequities that fall disproportionately on minorities, blue collar workers in changing industries, youth, women (especially single heads of households), and others isolated in our inner cities and depressed farm communities. Rapid technological change, declines in competitiveness on world markets and in our own domestic market, and an over-reliance on monetary policy to manage the economy coupled with a broad retreat from investments in human resource development and basic research, are all contributing to the inadequacy of employment and earning opportunities described in this report. High levels of joblessness and underemployment are no longer confined to low points in the business cycle.

Rather, the nature of unemployment, economic recovery and stable (though slow) growth no longer means factories adding back the second and third shifts or farmers making new investments in equipment and machinery. As the problems change, so must our solutions. Retreat from social and economic development programs and policies are no solution at all.

The federal government began its assault on joblessness during the Great Depression of the 1930's with the creation of various labor market institutions like the Employment Service and protections for workers with the unemployment insurance system and the minimum wage. Concern for making the transition to a peacetime economy immediately after World War II brought the Employment Act of 1946 and the first stabs at coordinating economic policy and planning through the creation of the Congressional Joint Economic Committee and the President's Council of Economic Advisors.

The Civil Rights movement took off in the mid-50's and led in the 1960's to the nation's reaffirmation of equal justice for all and rejection of "poverty in the midst of affluence." As labor market institutions and social programs were again expanded in the 1960's it became clear that these interventions had to also be coordinated with the government's overall economic policy.

The Full Employment and Balanced Growth Act of 1978 (a.k.a. Humphrey-Hawkins) amended and strengthened the 1946 Act by setting quantitative goals and providing a framework for removing disparities in unemployment rates among minorities, youth, women and others and the overall labor force. This Act also had sections dealing with reordering national priorities, controlling inflation,and bringing the Federal Reserve Board into the economic decision-making and goal-setting process.

As Congressman Augustus Hawkins (one of the chief authors of the 1978 Act) has concluded recently, however, "Economic policy making is in a shambles . . . Two administrations (Democratic and Republican) have merely made forecasts of what may happen to the GNP, unemployment and economic growth rates, and other economic indicators. Since passage of the act, we have yet to see an economic report from the president, a Federal Reserve Board report, or a Joint Economic Committee report that constructs the actual programmatic means for achieving 4% unemployment." This course of events must be changed. Much of the energy for the newly emerging "American Competitiveness" theme comes from people's concern with the need for increased job opportunities,income security and real improvement in their standard of living, and their aspirations to qualify for the jobs of the future. This theme, however, can be hollow and short lived if it does not lead to bold and decisive action that people can see in their everyday lives. The Humphrey-Hawkins mandate for reordering national priorities should lead to a careful cost-benefit analysis of current spending and a resolve to eliminate the unnecessary and wasteful costs of excessive joblessness and underemployment and the long term burdens associated with massive trade deficits and dependency on government transfer payments by those able and willing to work. On this front, the Congressional Budget Office's most recent estimates are that for one percentage point of excess unemployment, the federal treasury loses $44 billion in lost revenue and expenditures for unemployment compensation, food stamps and other transfer payments.

A new agenda for the nation is in order. We would call it, if you will, a Quality of Work Life Agenda or a Jobs 2000 Agenda that combines a range of approaches and creates a unified vision for high quality job growth, worker adjustment and investment in human resources. The National Committee for Full

Employment in consultation with its member organizations and several economists is currently at work on developing such an agenda, which will be completed later this Spring.

In the interim, there are several areas in which we believe that this session of the 100th Congress can take action. The highest items on this agenda include:

- creation of a nationwide worker readjustment and retraining system, including mandatory pre-notification of plant closings and permanent lay-offs, just compensation, and transition assistance;
- an increased minimum wage indexed to inflation and bringing workers and their families above the poverty level; and
- creation of a humane and effective welfare-to-work transition program that builds on the positive elements of the WIN program and provides incentives and leadership through the federal-state-local JTPA system (in partnership with the private sector) to assist welfare recipients achieve economic self-sufficiency
- expanded investments in our nation's young people (particularly minorities who will make up one-third of our entry level work force by the 1990's), with summer jobs programs linked to year round remediation and drop-out prevention efforts.

Readers of this report are encouraged to communicate their views on these and related matters to their elected representatives.

Senator **Sarbanes**. Thank you very much, Rabbi Saperstein, for a very forceful and perceptive statement. I think it might be helpful if, for the record, you could just briefly describe the National Committee for Full Employment and its activities.

Rabbi **Saperstein**. Let me ask Cal, who is the executive director, to give a brief outline of their activities.

Mr. **George**. Thank you, Senator Sarbanes.

The National Committee for Full Employment is a 501(c)(3) nonprofit public policy research and advocacy group concerned with both macro and micro economic approaches to solving our unemployment and underemployment problems. The essence of our efforts are to bring greater public awareness to both the nature of the problem and its severity, and also to various approaches that can and should be taken to solve and ameliorate these problems.

We are, in addition to working at the national level through our membership organizations, beginning a program to work with State and local coalitions on policies and their utilization of both their own resources and Federal resources for the unemployed.

Rabbi **Saperstein**. I would merely add that these organizations are the largest, most broad-based coalitions drawing from the economic public interest and religious sectors of the community in bringing these national organizations together and addressing these issues.

Senator **Sarbanes**. Could you tell me a bit about the genesis of this special report on Jobs '87? I gather it's being released this morning. We are very pleased to have it presented to the committee.

Mr. **George**. We, as a coalition, represent both major church and religious organizations in the United States, as well as organized labor, public interest and civil rights groups. There's been a good deal of attention recently on the Catholic bishops' pastoral letter on the U.S. economy. We decided to undertake and combine with our regular analysis of economic data an overview of other religious organizations' statements on unemployment and related issues and to bring those together in a way that said, as I think Rabbi Saperstein so well put, that the statistics are not inanimate objects; they are people; and that churches in particular, providing the moral leadership in our society, have recognized this and are helping us to chart a course toward assisting them.

Rabbi **Saperstein**. The first half of the report addressing the religious communities reflects what in my view is a very positive trend of religious groups in American life. For 200 years the religious community in America has served as a goad to the conscience of America. I believe that is its role.

It has done so in the past with fairly broad-based statements and the efforts through our churches and synagogues to create a climate of moral values that would then be applied into public policy forums of American life.

We have found, increasingly, in the past several decades that the public policy issues that we face have become on the one hand so complex and, second, of such urgency that it is now necessary for the religious groups that heretofore often stood on the peripheries of these debates to enter into them more directly, to use the experience, the skills, and the knowledge of the people from within their own communities to begin to do the kind of analysis of public policy issues and the application of ethical values that will help in an informed way through the various deliberations of public bodies, such as the Senate, in shaping the future of America.

The Catholic bishops' letters, both the peace pastoral and the economic pastoral, indicate the segments of one community that have received a lot of attention, but the same work has also gone on in other segments of the religious spectrum in America.

What this report does is to bring to bear some of the depth and breadth of the religious community's analysis of the economic issues that the Joint Economic Committee is dealing with and to try to apply those ethical insights.

Senator SARBANES. Will the agenda that I take it you are now in the process of preparing be in the form of a report, or a series of recommendations, or how will that be presented?

Mr. GEORGE. It will be in the form of what we call a policy framework, a short concise statement of the kinds of things that could be done to improve labor market institutions, the microeconomic policies in this country, and also with a view toward a more balanced approach to macroeconomic policies. And by a more balanced approach I am referring to things I think that Mr. Keyserling will also address when he comes before this panel next.

Senator SARBANES. Gentlemen, we thank you very much. I am familiar with the work of the national committee and I commend it. We are very pleased to have this report and also the highlights of the items on the agenda that you set out at the end of your statement. We look forward to the balance of that agenda and perhaps we can visit again together when you reach that stage. It might be helpful to do that. Thank you very much. We appreciate it.

Mr. Keyserling, if you would come forward, we are very pleased to have you here today. Let me simply say it's always a pleasure for the Joint Economic Committee to have you before it. You, of course, were Vice Chairman and then Chairman of the Council of Economic Advisers back at its beginning under President Truman. And over the years you have continued to be a very important economic thinker in our country and we are privileged to have you here today.

STATEMENT OF LEON H. KEYSERLING, PRESIDENT, CONFERENCE ON ECONOMIC PROGRESS, AND CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS UNDER PRESIDENT TRUMAN

Mr. KEYSERLING. Mr. Chairman, I am very glad to be here again. I would like to have my prepared statement considered for insertion in the record.

Senator SARBANES. The full statement will be included in the record as submitted.

Mr. KEYSERLING. I will proceed by reading from it but mostly by extemporaneous comments.

First of all, I am greatly stimulated by some of the questions put by the chairman of the committee and I must say—I won't ask for his agreement—that the implication of his views as expressed by his questions is very healthy and very sound and very encouraging.

The first point that was made or one of the important ones was on the whole question of forecasting and its accuracy. I think there is a very simple explanation for why the forecasts have gone so badly. It's as if somebody were trying to forecast how I was going to play tennis next year without learning anything about what kind of man I've been during the last 79 years or what kind of tennis player I was during 60 years or what kind of anything else.

If any kind of mature, nonideological, non-self-interest study had been made of what's happened in the laboratory of the great American economy, especially since its period of deterioration since 1969, you would have had something much better than a forecast. You would have a much better picture of where we are now, why we are there, what has gone wrong, what's the trouble with policies, and what we should do.

Perhaps an even more important commentary is that forecasts are not the name of the game if we accept the sound philosophy of the Employment Act of 1946 or what it means to be a great government and a great nation. When I worked for President Truman for 7 years, he never once asked me "what is GNP going to be a year or two years from now?" He never once asked "what is employment going to be a year or two years from now?" He said, "Where is it now and what should we do about it"—what we should do affirmatively, not yielding to the so-called automatic laws of how an economy works, but learning that the whole history of economic development and economic thought has been the increasing use of analysis and intelligence to make the economy work better.

Sometimes that's fully successful. Sometimes it's not altogether successful. What we did during the period of our greatest economic achievement during World War II, some of it is not relevant today. But most of it is highly relevant to what later economic policy should do by way of methodology—less restrictive, less extreme because we are not burning up half our product in fighting a great war—but highly relevant nonetheless in its basic elements, its basic organization, its basic identification of issues, its basic creation of a sensible, consistent, coherent national economic policy with regard to production, employment, and other matters.

Now without making any claims, but simply referring to the objective record of how the economy performed during the Truman years after World War II—5 percent average annual real economic growth, reducing unemployment to 2.9 percent, reducing inflation to 0.8 percent, balancing the Federal budget despite the Korean war—all that was accomplished by following what we had learned from the immediately previous World War II experience, with modifications to be sure. And nothing could be more important to our progress in the future than that we use the methods which we used then, with some modifications, and employ the methods which I have drawn than in everything that I say in this testimony about where we are, what we should do, what the quantitative elements of the policy should be, and how we should test them.

That is, you must have—to really have an economic policy and not an economic joke—you must have first of all a consistent set of short-range and long-range goals, not to be enforced by dictatorial mandates but as a guide to where you want to go, because if you don't know where you want to go you can't judge where you're going.

Second, an analysis of how major policies enter into the relationships among the three main components of GNP—private consumption, public expenditures and private investment—so that you can promote the relationships among the three which will maintain the equilibrium essential to optimum economic performance.

We don't have that now. We have heard testimony that the most urgent need is for more stimulus to private investment. All of my projections for the next few years have shown the need for a higher growth rate in private investment than in the other components. But I have insisted that we start trying to achieve this by tax concessions and other methods when the level of ultimate demand in the form of consumer spending plus government outlays is too low to keep factories above 80 percent utilization and to keep unemployment below 7 percent. This 7 percent is if you count only the full-time officially recorded unemployment. But counting also the full-time equivalent of part-time unemployment and the discouraged "dropouts," the true level of unemployment is not far from 11 percent. And looking at those directly affected by this amount of unemployment over the year, there were 45 to 55 million Americans in 1986 who were directly hammered by the unemployment of their breadwinners and forced below the poverty level if they weren't there already. I therefore emphasize the point that, instead of guessing where we're going to be, we look at where we have been and where we are now and why we are there.

At this point, I want to read the comment on page 1 of my prepared testimony, which I have single-spaced for emphasis.

> In response to your request for my evaluation of the current *Economic Report of the President,* I disagree thoroughly with this Report and the accompanying *Annual Report of the Council of Economic Advisers*—disagree as to the condition of the economy and the outlook, as to evaluation of domestic and international policies and their consequences, and as to policy proposals. Most fundamentally, I dissent from these two documents on grounds of economic, moral, and social philosophy embodied in the law of the land. My dissent converges on page 61 of the *CEA Report,* which merely forecasts dismal and even frightening quantifications of America's economic future through 1992. This embodies among other things a complete repudiation of the incontestably sound mandates of the 1946 and 1978 acts that national policies dedicate themselves to help shape this future in terms of our needs and potentials. Every page of my testimony details what I have just said.

In this connection, let me remind many, although I do not need to remind the chairman of the committee, that my many appearances before this committee and elsewhere have never been governed by the political complexion of the President or the Congress. This is confirmed by looking at what I said during the Carter administration, if I may refer to it, about the progressive deterioration of economic policy, all of which was borne out and which incidentally resulted in political defeat. I don't quite get the point made earlier today that from the economic point of view we should do so and so, but that from a political point of view we should do something else. If we do the wrong things from the economic point of view, the political reaction when the results are revealed will be such that we will be defeating the purposes of political approval.

Now let me refer briefly to some of the things covered more fully in my testimony.

First of all, I think there has been a complete misjudgment of the really crucial issues confronting the American people and their government. They are not inflation. They are not the trade imbalance, although I will have something to say about that. They are not the fluctuations in the value of the dollar, nor the deficits in the Federal budget, and so forth and so on. These do not compare with the deficits in the crucial matters in the American economy which are all important.

These include the deficit in the form of inadequate performance which during 1967–86, inclusive, has produced a forfeiture of not far from $29 trillion in GNP measured in 1986 dollars, and production is the support of all we do economically. We may use unwisely what we produce, but we can't use what we don't produce. Comparably, there was a forfeiture in the form of more than 95 million years of true-level unemployment during 1967–86, inclusive, a deficit which comes to about 81 percent of our total civilian labor force in 1986 and more than 88 percent of those employed full time. These deficits have meant deficits in the lives of millions of people who have been forced below the poverty-income ceiling, more and more shocking against our increasing capabilities.

These are the deficits to which national policy should primarily turn, and the irony of the whole situation is that every one of the less crucial problems which are preoccupying to an obsessionary degree—although they should have attention—every one of these less crucial problems has been aggravated by the primary deficits that I'm talking about and every one of them could be alleviated and some of them cured only by overcoming the primary deficits that I'm talking about.

Now, the obvious best example of this is the Federal budget. You can wave the recent legislation which most of the Congress who voted for it had grave doubts about and recognized as an abdication of the congressional responsibility—you can wave it in the face of everybody. But you are never, never—in view of inescapable national commitments—going to come much closer to a balanced budget nor achieve it unless you balance the national economy. Fundamentally—and I won't quote the figures because they're all in my prepared testimony in detail—fundamentally, it is not too much public spending, although there's been too much of some of it, and it is not too little Federal taxation, although there might well be more of it—that has unbalanced the budget. The budget has been unbalanced because you cannot squeeze the blood of adequate Federal revenues out of the turnip of a deliberately stunted economy, deliberately stunted in the name of stopping inflation and in the name of balancing the budget. The budget can and should be balanced by a reasonably full economy.

I have already indicated the forfeitures due to diverting ourselves away from the real purposes of our economy. I have mentioned the loss of not far from $29 trillion in national product. This means that if we had grown at a fair rate, at a rate less than we have achieved at some times in the past with less know-how and technology, and if we had paid attention to the mandates of the basic 1946 and 1978 laws, and far more important to our national needs from 1967 through 1986, inclusive, as I say, we would have had not far from $29 trillion more national production over these

20 years. In 1986 alone, incredible though the figure may seem, we would have been $2.8 trillion higher in national production than we actually were, which is the equivalent of 28 million homes destroyed at a cost of $100,000 each.

What I now say orally and my prepared testimony are based upon a detailed analysis in what I call a National Economic Performance Budget, about which I've had many articles in the New York Times and elsewhere over the years, but I don't care what one may call it. It's merely the exercise or approach which World War II and the Truman years and the first of the Walter Heller years as Chairman of the Council of Economic Advisers used with excellent results. But there has been a great sea change since 1966, and it's since 1966 that our real troubles began. We abandoned development of consistent goals, and use of economic policies to reach those goals. If this meaningful approach I have described had been followed, the conclusions would have been reached that we have terrific idle plants and idle manpower because we do not have enough ultimate demand to use these plants and this manpower fully. You know, I'm amused, even shocked, by the ease with which a lot of economists have been denegrating Mr. Keynes, when the only reason their policies have failed—or one reason why—is they have paid no attention to Mr. Keynes or applied him upside down. His basic finding was that you need to have enough demand, and demand means that bad word spending, to use the output fully, and that the cost of not doing so in economic and social terms is greater than any other cost in an economic and related social sense.

In line with this, I'm using the kind of performance budget I've already described, or whatever you want to call it. I have in my prepared testimony a detailed portrayal of what our goals should be—not prophecies that we are going to do very poorly for a number of years ahead, not prophecies that the current economic slowdown is likely to continue, not prophecies that we really don't know what we should do because the situation is so difficult—but goals to which we commit ourselves and apply policies toward attaining. My prepared testimony sets forth goals for increasing employment short run and long run, for increasing production short run and long run, for a balanced increase in the major components of GNP short run and long run. None of this means that the Government should preempt or prescribe the rate of production of steel. None of it means any of that. It means that the policies of the Government must not fly blind, that the policies of the Government must be definitive and consistent, that the policies of the Government must be adjusted and shaped and corrected year by year toward achievement of these goals.

The only three policies that I'm going to mention in some detail in this oral presentation are, first of all, Federal budget policy. This is the most important. Why have we forgotten that, however much we think that the budget ought to be balanced, the budget wasn't created and doesn't exist to be balanced? We could balance it by shutting down the Government. We could balance it by having 10 billion dollars' worth of expenditures and 10 billion dollars' worth of taxes. But this would forget what the budget, indeed the Government is for, which is to do for the people, to allocate to the public sector that which, as Lincoln said, "Needs to be done but cannot be done so well by the people in their separate and individual capacities." That's what the budget is for.

Applying those tests, and including the economic test of what budget is compatible with movement toward a full economy, we need now to increase the budget rather than decrease it. Whether the specific amounts that I set forth in my prepared testimony can be challenged or not—and details always can—we have to increase the budget to have the economy moving in the direction that will help to meet the fundamental economic and related social needs of the Nation and which coincidentally, but not all importantly, will move toward a balanced budget in surplus by 1992, which is a 5-year period from now, the same length of time specified originally in the Humphrey-Hawkins Act amending the Employment Act of 1946.

In contrast with this, my prepared testimony traces what's been happening. I trace the shocking cuts, in the budget, not overall but as a percent of GNP during the most recent years, and the even greater ones portended for the years just ahead. With slight increases in national defense outlays, there are shocking cuts, in the fiscal year 1988 and later projected budgets, in some of the most important elements in economic progress and human well-being, in manpower programs, in education, in urban renewal, in agriculture—the very areas of some of our most pressing problems, the very areas where expansion is far more needed than in some types of gadgetry.

After indicating the shocking cuts, I set forth the needed increases. And then I demonstrate that these needed increases in the budget would, of course, mean larger budget outlays in dollars between now and 1992 than where we're headed, but would, combined with additional other policies which I come to including improved monetary policies, so increase the GNP or total national product that the increase in the national product would be several times the increase in the Federal budget. That's what makes sense, and that's how to balance the budget by increasing Federal revenues through higher real economic growth.

Then coming to money policy. I don't want to start a debate on this, even though since the Federal Reserve Board-Treasury accord of the early 1950's there has been the greatest public economic or financial travesty in the history of the American Republic. Billions of dollars have been redirected in the wrong direction by high interest rates, wrong morally and socially, and devasting economically.

The costs of the increased interest rates, as imposed upon the Federal budget in calendar 1986, came to about half or more of the total deficit in the Federal budget, and these added interest costs not only serve no useful purpose but have a highly deleterious result. The increased interest costs imposed upon the Federal budget in that year were several times the fiscal 1987 budget outlays for each of the crucial budget programs which I have mentioned, most of which are being slashed.

I believe we ought to have Federal legislation setting some ceilings on interest rates. A very strong argument for this is that we had this at times in the past and it worked. I believe we should have a legal requirement that the Federal Reserve Board expand the money supply roughly in accord with the real growth rate need of the economy, this need not as defined by the Federal Reserve Board nor by Mr. Volcker because he isn't particularly concerned about it, but as defined by a properly responsive President and Congress acting under the Employment Act of 1946.

If the Government's finding is that the real average annual economic growth rate should be a given percent, then the real growth of the money supply should not continue to be what it has been. To be sure, we hear that the growth rate in the money supply has been too high at times, looking at it in current dollars. But what really helps to support the real growth rate of the economy is the real growth rate of the money supply. And just as we apologize for high interest rates by adjusting for the increases in the form of general inflation, why don't we pay any attention to inflation in determining what the growth rate in the money supply really is? Let me give you a shocking figure. From 1955 through the end of 1986, the real average annual growth rate in the nonfederally held money supply was only 0.9 percent. You cannot float the economic ship, except if you want it to be driven over Niagara, on that kind of growth rate in the money supply.

In addition, we should have selective rather than aggregative monetary restraints. We used selective restraints successfully at various times. We should use them again to help those first who need help most instead of to feed the fat and starve the lean.

Most important of all, we should puncture the ridiculous proposition that the Federal Reserve Board, as it is in fact, should be entirely independent of the President and the Congress. If so, why should not the tax policy be entirely independent? Why should something which so vitally affects the whole economy and all the people be left to a group of appointed people—appointed by the President to be sure—with high policy participation by the heads of some of the Federal Reserve Banks who are private citizens and private money makers? This is not good government practice. The Federal Reserve was created by the Government and is supported financially by the Government, and its operations should be in fully public hands.

I talk about what the Government should do, not because of predilection with government but because after all I'm talking about public statutes and I'm talking to and I hope in the interests of Members of the Congress and members of the administration who are government. I'm talking about what their policies should be. Fiscal and monetary policies are public policy.

Third, there is the matter of wage policy. Going way, way back, the predilection of the Government has been that too high a rate of wage increases was the main cause of inflation. This has never been supported by the empirical evidence, and I deal more fully on the causes of inflation in my prepared testimony. The particular animadversion to wage trends has abated recently, in view of the transparent evidence that the real earnings of nonagricultural production workers are lower than they were 10 years ago, and the figures on this are quoted in my prepared testimony. The growing deficiencies in wage earnings are such a large factor in the deficiency in private consumption that how can public policy allow this to continue without expecting to happen what is now happening in the economy?

I believe in a national wage policy, so to speak. But I don't believe it should be put into the hands of people whose economic thinking and philosophy are so wrong. Those who are conspiring to do the wrong thing on fiscal and monetary policies would do the wrong thing on wage policy, as has been done so many times in the not distant past. National wage policy was done right without controls during the early Kennedy years and with controls because they were necessary during World War II and during part of the Korean war.

I intimated at the outset that I did not opt much for conventional forecasting. I don't think saying what kind of tennis player I'm going to be next year is a forecast, and I don't think saying that the way things are going now—and this was admitted by most of those who testified today—1987 and 1988 will continue the dreary process of what I call the consistent roller-coaster economic performance during 1967–1986, inclusive. We must remember, in this connection, that it is not only a straight line on a blackboard that is consistent and indicative. A jagged line may be very consistent, if the ups and downs continue in a regular pattern and thus clearly indicate the long-term trend. Since the end of 1976, we've had a remarkably consistent economic performance, all leading to the wrong results. We have had recessions one after another with each one tending to generate more unused resources and more unemployment, and aborted recoveries with each one including the late 1983 to mid-1984 sharp upturn of tending to leave more unused resources and more unemployment. At the peak of that sharp recovery, we had more unemployment than debts the depths in of several recessions back. This is amazing, intolerable, and unacceptable.

So I forecast, if you want to call it that, that the dreary rate of 2 to 3 percent average annual growth will continue this year and hopefully next year—hopefully I say only advisedly—and that it is only a matter of what is only a very short period of time in the life to date of the American economy before we will be in another recession which could be worse than the last one.

Happenings in the international field, which I have tried to review in proper perspective, should be weighed in relationship to domestic developments. We should start worrying a little bit less about how much too many Americans are spending overseas and a lot more about how much too little more than two score million Americans are spending domestically to get by at home. And much on more of what they ought to be enabled to spend much more on things at home are things that neither Japan nor Germany nor any other country could compete with us on—decent housing, decent schools, better transportation—and I could carry this list on indefinitely. Why don't we begin to realize that, whatever we say or do, there's going to be an ever-changing pattern in the relationship between our exports and our imports, partly because we couldn't remain forever the dominant economic growth in the world, partly because other countries are developing, and partly because Americans make free choices as to where they buy. We need to start to as we did when other things were dispossessed in the domestic field because of technological changes and needs and wants, for example, the horse and buggy. We need to start long-range planned and increased production of many things, many of which involve the Federal budget, thus getting more workers into the production of domestically produced products that we need much more of. I have already mentioned housing, transport, education, and health services, this would soon, in magnitude and importance, so outweigh the imbalances in our international exchange of goods that that problem would be shrunk to manageable proportions.

I want to say just a word, really in conclusion, about what Chairman Sarbanes said about protectionism. We started out, under Adam Smith, with what was called laissez faire. Free trade meant leaving things alone, and laissez faire more generally meant let economic trends be determined by the automatic working of a supply and demand system or by the immutable "laws of economics." But for more than two centuries since then, we have happily gotten away from the idea of laissez faire, of allowing the domestic destinies of nations to be determined without the aid of the conscious intervention of those who alone really have responsibility for the whole, this means public instrumentalities, it means government.

We can't really square this trend with continuation of the idea of absolute free trade. Under modern circumstance, the domestic and the international economies are part and parcel of each other. But I would not call it "protectionism" to turn some of our efforts toward modifying the discrimination against us on the part of some other countries who use their own national policies to exclude or limit our sales to them, even while they benefit by free market access to us. I should call that an effort on our part to avoid their protectionism in order that we may not be driven to protectionism. I think that such action on our part is against protectionism, and I think it's a problem which we must be interested in because it's the way we affect each other and in that sense we're part of one world.

So I'm glad to have this opportunity to express my complaints, shall I say, about the way things are going, with a hope that what I say may have some, albeit infinitesimally small, effect upon our public-policy dedication to achieving the true promise of America, serving the interests of the American people, and strengthening our free institutions.

[The prepared statement of Mr. Keyserling follows:]

PREPARED STATEMENT OF LEON H. KEYSERLING*

Mr. Chairman and Members of the Committee:

I welcome this opportunity to appear before you. In responding to your request that we make forecasts about this year and next in shaping current national policies, I think it is best to start with what we know and not with what we guess. The best guide to policy decisions--and we always act in the present even when we want to affect the future--is not to look through a crystal ball into that future. We can best decide what we should do now for today and for tomorrow by relying primarily upon the long actual record of the events and policies of more than four decades during existence of the Employment Act of 1946 and since 1978 the Humphrey-Hawkins Full Employment and Balanced Growth Act. Especially, I shall base my analysis and conclusions upon what has been happening during the two decades from the end of 1966 through 1986. For during this long and trying period, we have experienced a roller-coaster economic performance fundamentally consistent in its essential nature, main causes, and unfortunate economic and related social consequences. This provides our best guide as to how we can and should begin to achieve instead of continuing to squander the still-unrivaled potentials of the U.S. economy, its institutions, and its people--an effort so meaningfully defined by the two Act to which I have just referred.

In response to your request for my evaluation of the current Economic Report of the President, I disagree thoroughly with this Report and the accompanying Annual Report of the Council of Economic Advisers--disagree as to the current condition of the economy and the outlook, as to evaluation of domestic and international policies and their consequences, and as to policy proposals. Most fundamentally, I dissent from these two documents on grounds of the economic, moral, and social philosophy embodied in the law of the land. My dissent converges on page 61 of the CEA Report, which merely forecasts dismal and even frightening quantifications of U.S. economic performance through 1992. This embodies among other things a complete repudiation of the incontestably sound mandates of the 1946 and 1978 Acts that national policies dedicate themselves to help shape this future in terms of our needs and potentials. Every page of my testimony details what I have just said; and what I say from the last paragraph beginning on page 13 through the first full paragraph on page 14 condenses the basis of my dissent. My many appearances before this Committee have made it clear that the political complexion of the President or the Congress has never colored my views.

Our long failure on economic and related social grounds, mainly and consistently from late 1966 to date, has been and still is based upon an upside down set of priorities in dealing with national economic policies, involving also a confusion of means and ends. Predominant focus has remained upon the immense Federal deficit; chronically rising inflation; the huge deficit in our imports compared with our exports; and the wide fluctuation in the international exchange value of the dollar. To a high degree, we have forgotten that these are but means to help achieve the ultimate purposes or ends of our economic society, by overcoming the grave chronic deficits represented by low average annual real economic growth, chronically rising unemployment, the intensifying maldistribution of national income and enjoyments, the increase in poverty, and the growing shortfalls in Federal assistance to our great national priorities, including but not limited to education, health services, housing, and public income supports where needed. These deficits in truth tower above, in size and adverse consequences, the deficits and other troubles which now absorb relatively too much of our attention. The greater also influence very much the smaller. [illegible]

Our ultimate or end objectives are well served or ill served, depending upon whether our actual real growth in the production of goods and services and in the expansion of employment opportunity falls far below or comes close to our optimum potentials, and upon how viably and equitably we distribute goods and services toward the goals of full production and full employment. There is no automatic nor heaven-ordained eternal rule as to whether these end objectives are best served by a deficit or surplus or balance in the Federal Budget; by rising or stable or falling prices; by pluses or minuses in our international balances of trade and accounts; or by the trends in the international exchange value of the dollar. The magnitudes and direction of the means should be adjusted to facilitation of the ends and judged in terms of end results. For a number of years and now, by elevating the means to superior importance per se, we are gravely sacrificing ends to means. And by doing this, we are chronically getting worse and worse results even in terms of the means themselves. This I shall illustrate in due course.

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*President, Conference on Economic Progress. Chairman, Council of Economic Advisers under President Truman.

I come now to the most important among the deficits I have cited. In a roller-coaster economic performance, we have had six recessions since 1953 with four of these coming after 1966, and with each succeeding decline tending to be larger than the ones before and each succeeding recovery being aborted further and further shorter of full recovery. The real average annual rate of economic growth has declined alarmingly, from slightly above 5 percent 1947-1953 and 1961-1966 to only 3.1 percent 1966-1969, 2.5 percent 1969-1986, 2.4 percent 1977-1986, and 2.0 percent 1979-1986. Despite the sharp upturn in the real ~~average~~ annual rate to 9.8 percent ~~fourth~~ third fourth quarter 1983-~~first~~ fourth first quarter 1984, the rate was only 2.5 percent 1981-1986, and still lower during the second half of 1986 and in early 1987. Viewing the confirmed pattern under current policies, most of the most competent people prone to make forecasts look toward another recession in the not too distant future.

The costs of this roller-coaster has been stupendous. Expressed in 1986 dollars, the forfeiture representing the difference between actual GNP and GNP at reasonably full production during the 20 years 1967-1986 (inclusive) aggregated ~~almost~~ not far from 29 trillion dollars, not far from seven times our annual rate of GNP in fourth quarter 1986. In 1986 alone, the forfeiture was in the neighborhood of 2.816 trillion, this being how much we fell short of what we would have achieved if we had maintained a reasonably full economy throughout the 20 years.* This forfeiture is the equivalent of more than 28 million houses at an average cost of $100,000.

During the same 20 years of the roller-coaster, the average annual rate of full-time civilian unemployment (the officially reported rate) was about 6.2 percent. But the true level (taking account also of the full-time equivalent of part-time unemployment and those not officially counted as unemployed because the shortage of job opportunities discouraged them from actively seeking work) was about 8.9 percent. In contrast, if there had been reasonably full employment during these 20 years, the unemployment rates (not including "frictional" unemployment) would have been, respectively, 2.9 percent and 4.1 percent. Thus, the extent to which the roller-coaster actual performance fell short of a full-employment performance meant a forfeiture in the form of ~~almost~~ more than 95 million years of unemployment above the "frictional" level. This forfeiture came to about ~~84~~ 81 percent of the total civilian labor force in 1986 and more than 88 percent of those employed full-time. The true level of unemployment in 1986 stood at about [illegible] 11.07 million, or about 9.4 percent of the civilian labor force. Taking into account the rotation of unemployment among different workers within any given year, and taking account also of family dependants, 40-45 million Americans in 1986 were directly hit by unemployment, which forces a large part of them below the poverty ceiling even if they were not already there while employed.

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*Allowing for the reduced potential in 1986 due to the shortfalls during the long period under review, GNP in 1986 would have needed to be at least 500 billion 1986 dollars higher than it actually was to represent a reasonably full economy.

These forfeitures penalize almost everyone through their effects upon the whole economy, but they are vastly aggravated by the widening gap between the house of have and the house of want, and by greatly increased poverty and deprivation. Total persons (in families, unrelated subfamilies and unrelated individuals) living below the poverty ceiling, as defined by the U.S. Department of Commerce), rose from 21.47 million or 12.1 percent of the population in 1969 to 33.064 million or 14.0 percent in 1985 (1986 not available). Again according to the Department of Labor, those living above the poverty ceiling but not more than 25 percent above it, are below the income required to maintain a minimum adequacy level of living. These may be said to live above poverty but in deprivation nonetheless. The total number of these in 1985 came to 11,102,000 or 4.7 percent of the population. Thus, all persons living in poverty or in deprivation came to 44,166,000 or 18.7 percent of the population. The intensifying maldistribution of income and the growth in the number and percentages of families living in poverty and/or deprivation is further illustrated by these facts: Among families, the percent of money income accruing to the lowest fifth declined from 5.5 percent in 1973 to 4.7 percent in 1985, while the shares of the highest income fifth rose from 41.1 percent to 42.9 percent.

What have been the main national policy errors initiating and perpetuating the roller coaster? First, a chancy congeries of improvised, ad hoc, poorly integrated, and at times inconsistent policies has come to take the place of a unified comprehensive, and purposeful national economic policy. We no longer make manifest one increasing purpose in our national effort, understood and supported by the watchful eye of an informed people. We do not develop and put together into an overall consolidation the quantified major goals essential to this purpose, nor do we forge and fuse national economic policies in support of those goals. As already stated, we confuse means and ends, and turn them upside down. We do not appraise the balanced relationships among the main components in the economy essential to economic equilibrium at reasonably full resource use, but instead distort these relationships further by purely ideological predilections under the impact of competing interest. And above all, although the Federal Government must be the principal factor in facilitating these purposes, we grossly denegrate the role of the Government and preach that it should do less and less when in fact it needs to do more and more in the evolving nature of the U.S. economy and its problems.

Time permits selection of only the most important specific examples of where we have been going wrong and still are. The Federal Budget as the most powerful and vital instrument of national economic policy comes first. We have become penny-wise and pound foolish in our attitude toward this Budget. A Federal deficit somewhere in the neighborhood of 200 billion dollars is much less than 5 percent of our current gross national product. That is high, but why make it a national obsession? Most economists admit that the economy would have done even worse during recent years if the deficit had been much lower. And if the current deficit were drastically reduced when the economy is still operating at an annual GNP rate of at least 500 billion 1986 dollars short of reasonably full production, when plants have been tending to operate at only about 80 percent of reasonably full capacity use, and when the true level of unemployment is about 11.7 million or about 9.4 percent of the civilian labor force, the economy would be still worse off. Despite the Gramm-Rudman-Hollings legislation which even many of those who have voted for it recognized as an unsound approach and a large abnegation of Congressional responsibility, there is no way in the world under unavoidable and essential national commitments to come even close to balancing the Federal Budget without derailing the roller-coaster economic performance and getting on our way to a reasonably full economy. The tremendous Federal deficits have not been due in general to too much spending nor to inadequate rates of taxation, but rather to inability to squeeze the blood of adequate Federal revenues out of the turnip of a stunted economy. In any situation short of total war, with a reasonably full economy and the tax revenues which it would produce, we would have a Federal Budget balanced or in surplus. Beyond all this, we need to restore recognition that the Federal Budget does not exist to be balanced; it exists to improve the economy and do justice to our great national priorities. This requires its use to allocate to public purposes (and to help allocate through private actions) that portion of our total national output which needs imperatively to serve both economic progress and justice. And this demands the help of the Federal Government because, as Lincoln said, it cannot so well be served in any other way.

The trends in national monetary policies guided by the Federal Reserve have, since the Treasury-FRB accord toward the end of the Truman Administration, come close to the damage brought by the erroneous fiscal policies later on and far exceeded them in obvious violation of common sense. Insufficient growth rates in the money supply have been closely associated with economic stagnation and recession. Although we frequently hear that the nonfederally held money supply has grown too rapidly and contributed to inflation, this is based upon the error of looking at nominal growth rates rather than real growth rates as adjusted for inflation. For it is the real growth rate which so greatly affects the real GNP growth rate. The average annual real money-growth rate from 1955 through 1986 has been only 0.9 percent, and sharply negative trends have been associated with stagnation and recession. Interest rates have soared unconscionably since the Treasury-Federal Reserve accord at the start of the 1950's, and we should not fall for the claim that interest rates have not remained much too high in that the prime rate dropped from about 20 percent at its peak to 8.33 percent in 1986 and about 7.5 percent now. This rate was only 3 percent in 1952. The current interest rate on home mortgages, hovering in 1986 and now close to the double digit rate, is virtually prohibitive of new home acquisition by those in the lower portion of the income structure, and the inadequate average annual amount of home building with its feast-and-famine characteristic is a major factor in the entire roller coaster. The increases in average annual interest rates 1960-1986 ~~1952-1984 (I have not yet been able to develop later figures, which would be still more disturbing)~~ have imposed additional interest costs of more than 685 billion dollars ~~more than half a trillion dollars~~ upon the Federal public debt, almost 5 ~~more than 1.6~~ trillion upon the total private debt, and, including state and local, almost 5.9 ~~5.4~~ trillion upon the total private and public debt. The cost due to to interest-rate increases in ~~excess interest cost in the Federal Budget by~~ calendar 1986 ~~1985~~ came to about ~~more than~~ half of the total Federal Budget deficit ~~(and much more by now)~~ and was many, many times fiscal 1986 proposed outlays for education, or for health services and research, housing and community development, public assistance, or manpower programs. Beyond all this, monetary and fiscal policies have often been deliberately hitched to opposite sides of the economic cart to pull in opposite directions, when they should be made harmonious under a unified national economic policy.

Both the erroneous fiscal and monetary policies have evinced no sizeable effort to achieve the viable balance among the main components in the economy conducive to optimum performance, but instead have distorted it further. The guiding presumption has been to encourage faster growth in private investment in producer facilities to expand production capabilities, and to restrain the growth in ultimate demand represented by consumer and public spending. Private investment, to be sure, has grown too slowly relative to the requirements for a full economy, but too rapidly relevant to ultimate demand. Contrary to the national policy position, any deficiencies in private investment have not in general been due to shortages in retained earnings nor in available loan funds, but rather to the presistent deficiency in ultimate demand which has been mainly responsible for the stagnations and recessions. The examples which I now select are consistent with developments during many earlier years. During what might be called a "boom" period, from fourth quarter 1982 to second quarter 1984, the average annual real growth rate of investment in plant and equipment was 9.1 percent, contrasted with only 4.6 percent in ultimate demand. In support of this, the real average annual growth rate in corporate profits (including inventory value admustment) during the same period was 40.4 percent, while the rate for wage and salaries as the main factor in private consumer spending as part of ultimate demand was only 5.3 percent. From second quarter 1984 to fourth quarter 1984, a "slow down" period, the annual growth rate for investment in plant and equipment raced ahead at 9.7 percent, compared with only 2.7 percent for ultimate demand. This, although corporate profits were down 9.7 percent and wages and salaries up 3.8 percent. From fourth quarter 1984 to fourth quarter 1986, really a "stagnation" period the figures were 2.2 percent for investment, 4.2 percent for ultimate demand, 3.2 percent for corporate profits, and 3.1 percent for wages and salaries.

The excessive favoritism toward private investment has been accompanied by the hue and cry that the rate of saving and accumulating savings are deficient. This neglects the impact of the regressive distortion of income under recent and current national policies. This distortion has provided relatively excessive saving among those at the top of the income structure and deficient saving and frequently dangerous dissaving among those lower down in the income structure. The extraordinary stock-market boom during the most recent months is mainly explained by this. Although widely regarded as favorable, this boom in fact indicates, in lesser degree to be sure, the kind of imbalance preceding the great stock market boom in 1929 just before the Great Crash.

Meanwhile, the dissaving and tremendous borrowing at low income levels are a greater threat to the economy, although not so recognized by the powers that be, than the borrowing reflected in the Federal deficit which now evokes excessive public concern. From 1972 through 1984 (later data not available to me), the ratio of consumer credit to disposable income rose from 13.7 percent to 22.6 percent, and the ratio of consumer debt to disposable income rose from 38.3 percent to 75.0 percent. It would be unwise to reduce the weak props of excessive consumer borrowing in support of weak current economic performance before stronger props are inserted through concentrating upon improved income distribution and higher consumer incomes among those too low down.

In putting forth my recommendations for moving promptly from the dreary and disheartening performance record which has afflicted us for so many years toward actualizing our full potentials as rapidly as feasible, I must first of all depict succinctly the means which I have used to set the goals and policies about to be set forth. These means are not my own concoctions; they are substantially what was done during World War II when our performance exceeded the most fanciful expectations, and what was done with the aid of the first Council of Economic Advisers during the Truman years when, giving proper weighting to all factors, a better record was registered than at any time since despite a complex of difficulties greater than at any time since. And they are the means mandated (but now ignored) in the Employment Act of 1946 as amended by the 1978 Humphrey-Hawkins Full Employment and Balanced Growth Act, with the latter merely codifying the policies and procedures followed when we did best.

My method thus involves working out a short-range and long-range national portrayal of needs, resources, and national policies for now and for the future, ample in scope and consistent throughout. This exercise, tested and corrected from year to year, takes the form of what I have called a National Economic Performance Budget. The deviations of actual performance from this Performance Budget have come very close to representing the shortfalls in our efforts which I have described above. Obviously, others will not agree precisely with the details I set forth. But all should recognize that the method used is derived from successful experience, and that the results I reach are based sufficiently upon experience and analysis to be useful and pertinent to policy makers engaged in fortifying an improved national economic performance.

The exercise which I have just described indicate that GNP, measured in 1986 dollars, should be up 232.5 billion or 5.3 percent from 1987 to 1988, and ~~$~~1,26[illegible] trillion ~~billion~~ or 28.9 percent from 1987 to 1992. The end year 1992 is chosen because it embodies the reasonable five-year time period set forth in Humphrey-Hawkins, readjusting for the time elapsed since enactment of that law. Full-time civilian employment should be lifted by 2.4 million from 1987 to 1988, bringing full-time unemployment down from 8.0 million or 6.7 percent to 7.5 million or 6.2 percent. From 1987 to 1992, full-time employment should be lifted by 12.4 million and full-time unemployment reduced to 5.4 million in 1992 and 5.2 million or 4.0 percent by fourth quarter 1992. Toward these ends, for the two respective periods, consumer spending should be lifted 149.7 billion and 827.0 billion; gross private business investment, 37.7 billion and 189.3 billion; and total government outlays for goods and services 45.1 billion and 249.1 billion. Consistently, the average annual real growth rates in these categories should be in the neighborhood of 5.2 percent for GNP and consumer spending, 5.0 percent for all government outlays for goods and services, and considerably higher for gross private domestic investment including net foreign. The average annual growth rate in Federal Budget outlays is goaled at 2.7 percent for the shorter and longer periods.

My careful estimates as to the effects of current national policies as projected, closely in accord with those of other higher competent sources, and also close to but not exactly in accord with those made by the Administration in the current Annual Report of the CEA, are in the neighborhood of an annual average of 3.0 percent for GNP, consumer spending, and gross private domestic investment. But public outlays for goods and services at all levels are estimated at only 2.0 percent for both the shorter and the longer periods. Most significantly, the growth rate in Federal Budget outlays is ~~set forth at~~ estimated minus 2.7 percent for the shorter period and minus 0.1 percent for the longer period. The unemployment rate is estimated at 6.8 percent for 1987 and 6.7

percent for 1992, although the CEA Report's estimates are 6.7 percent/ and 5.5 percent (still very unacceptable).* The projection estimates under current national policies, compared with the results under the approach espoused herein, import a 1987-1992 GNP differential of 2,046.2 billion 1986 dollars, and 917 million in employment opportunity.

Toward reaching the needed and feasible goals, I have already stated the general principles which should govern the use of the Federal Budget. In most disturbing contrast, there has been a drastic shrinkage in the Budget, measured in the fiscal 1988 dollars used in the President's fiscal 1988 Budget. The total Budget has been cut from 1,057 billion dollars in fiscal 1986 to 1,024 billion in the President's Budget for fiscal 1988, a reduction from 23.78 percent of GNP to 21.74 percent (GNP as estimated by the President). Outlays for national defense, international affairs, science, and space would rise but very slightly over this period. But those for all domestic programs would drop from 740.4 billion to 700.1 billion or from 16.66 percent to 14.86 percent of GNP. Outlays for income securities other than veterans would hardly change, but would drop from 9.04 percent to 8.57 percent of estimated GNP. Outlays for agriculture, natural resources, and energy would drop from 53.2 billion to 43.9 billion, or from 1.20 percent to 0.93 percent of Presidentially estimated GNP. Outlays for manpower programs including public service jobs would drop slightly from 6.3 billion to 6.0 billion or from 0.14 to 0.13 percent of GNP. Outlays for education would drop from 18.6 billion to 14.5 billion, or from 0.42 percent to 0.31 percent of GNP. Outlays for health would hardly change but, would drop from 0.86 percent to 0.83 percent of GNP. And outlays for housing and community development would drop from 17.6 billion to 17.1 billion or from 0.40 percent to 0.36 percent of GNP.

Diametrically in contrast, the Budget goals derived in the/model Federal Budget in the Performance Budget I have described would rise as follows, again measured in fiscal 1988 dollars: Total expenditure goals for fiscal 1987 would be 25.8 billion higher than in the estimated 1987 Budget, and in 1988 would be 83.0 billion higher than in the President's Budget for 1988. By fiscal 1992, they would be 124.5 billion higher than in the goals for fiscal 1988, and 207.5 billion higher than the President's 1988 Budget. For all domestic programs, the increases for the respective years would be 25.8 billion, 84 billion, 87 billion, and 171.0 billion. These increases are apportioned among the categories of domestic expenditures in accord with estimated needs, with relatively enormous percentage increases in manpower programs including public service jobs and in housing and community development.

Using the Federal Budget to help balance the American economy and meet imperative social and human needs is infinitely more important than balancing the Federal Budget itself. The Budgets advocated herein, in contrast with those derived from current and prospective national economic policies, would yield in fiscal 1988 ~~during the~~ years 1987-1992 an annual average difference between the two Budgets of 115.2 billion 1986 dollars, contrasted with an average annual difference of 372.5 billion in GNP, very substantially in consequence of the differences in the two budgets. It is hard to imagine a more profitable bargain than this in purely economic and financial terms. Moreover, the higher Budget outlays would support indispensable national priority purposes of great economic and social value. And even this anlaysis does not lay bear the differentials embodied by these alternative Budget (and other) policies--differentials in the lives and livelihood of millions of American families who are sinking fast under current national policies and developments. Nor does it reveal fully the huge benefits for those throughout the entire income structure who do so much better when the economic machine is running smoothly in the right direction than when it is fluttering, sputtering, and moving in a roller coaster of ups and downs.

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*For CEA estimates, see page 61 of current Annual Review.

Although extraordinary Federal deficits during some periods serve a useful purpose, it is desirable in the long run to bring the Budget into balance when economic and social conditions justify this result. This involves, not pseudo-heroic grandstand plays like some recent legislation which could be damaging beyond description, but instead precise examination of how the Federal Budget may ultimately and usefully be brought into balance in a full and well-balanced economy. My National Economic Performance Budget, of which my model Federal Budget is an integral part, demonstrates that, using the Federal Budget to bring about a full rate of real economic growth would balance the Federal Budget by calendar 1992, while following current national policies and accepting their results would yield a deficit estimated at 85.6 billion in that year. The respective average annual Budget deficits 1986-1992 are estimated at 97.3 billion dollars under the more creative approach contrasted with 122.7 billion under the now-in-effect approach.

A constructive and successful Federal spending policy, as my quantifications of it demonstrate, must help redistribute income and other services in a progressive rather than a regressive direction. For, as has also been demonstrated, the failure of ultimate demand (and especially consumer spending and income) to keep up with our productive potentials has been the fundamental cause of the roller coaster with all its dire consequences.

The same comments apply to a long procession of changes in Federal tax rates which have been highly regressive instead of progressive. Personal tax increases 1939-1945 during World War II adhered strongly to the progressive principle. For a married couple with two children and a $5,000 income, the increased tax take resulted in a 12.1 percent drop in after-tax income, while for a $200,000 a year family the drop was 51.2 percent. But under the personal tax cuts 1945-1963, the gain in after-tax income was 4.8 percent for the $5,000 family and 47.2 percent for the $200,000 family. In the influential 1964 personal tax cuts, the gain in after-tax income was 1.6

percent for the $5,000 family and 16.0 percent for the $200,000 family. Although the stimulative influence of the 1964 tax cuts was very short lived, they were vigorously used in support of later tax cuts in the same vein. The personal tax cuts under the *Economic Recovery Act of 1984* were only 0.6 percent for the $10,000 family and 23.8 percent for the $500,000 family.

Meanwhile, under various Acts, the allocations of tax cuts between stimulation of investment and consumption embodied highly inimical economic and social *desiderata*, for reasons already stated. To take one example, the permanent effects in 1973 and thereafter of the 1971 tax cuts allocated 7.4 billion dollars to investment and only 2.7 billion to consumption. To grasp the full magnitude of this disparity, one must recognize that consumption is about four times as high in dollar terms as gross private domestic investment. It follows that, in the interest of balanced stimulation, the allocation to the consumer should have been about 29.6 billion. Hence, these misdirected tax cuts did not yield the desired results.

The so-called "tax reform" Act in 1986 desirably removed the Federal tax burden previously imposed upon very low income families. But economically speaking, this was counteracted by increasing the tax upon middle-income groups, highly undesirable when consumer buying remains so deficient. There was a tremendous reduction in the tax rate imposed upon those of very high income, and many of these will escape the counterbalancing effects of closing some of the loopholes. And even allowing for the effects of these closings, the reduction of the marginal tax rate leaves those of very high income immensely better off, relatively and absolutely, than they were when progressive taxation was the order of the day, and when the marginal rate was 90 percent or even when it was about 50 percent later on. Further still, most of these loopholes should have been closed many years ago without so-called compensating action. It is a misnomer, in my view, to call the 1986 tax legislation a "reform" just because it makes the tax structure not quite as bad in some respects (although worse in others) as it was in consequence of the wrongful tax acts from 1964 through 1981. It is my strong conviction that the urgently needed changes in the spending side of the Federal Budget be undertaken before embarkation upon another donnybrook about tax changes. But at the earliest feasible opportunity, there should be tax action to carry us substantially back to the decent and defensible tax structure which we had a number of years ago.

I have already introduced quantitative evidence that the prevalent monetary policy since the very early 1950's has conspired with tax and spending policies to combine poor economic performance with indefensible human and social policy. With respect to monetary policy, I submit that early legislation place ceilings upon some types of interest rates; require that the money supply average real annual increases in accord with the need as to adequate real average annual GNP growth; require selective rather than aggregative money policies be employed to help those who need help most instead of feeding the fat and starving the lean; and, above all, puncture the practice that the Federal Reserve be entirely "independent" in fact; instead, it should be made reasonably responsive to the President and the Congress. If money policy should be entirely independent of the President and the Congress, why not tax policy?

Quite properly, those in the Executive Branch and the Congress involved in national economic policy have sought to influence income policies in the private sector, especially wage trends. The chronic official position, exhibited from time to time by control, guideline, or jawboning has been that excessive wage rate increases have been mainly responsible for price inflation. This approach, contrary to empirical observation, has contributed greatly to the deficiencies in consumer income and spending, measured against the requirements for eocnomic balance and reasonably full resource use. This particular error has recently abated, in view of the intensifying evidence as to adverse trends among the incomes of wage earners. For production or nonsupervisory workers in all private nonagricultural industries, the index (1977=100) of adjusted hourly earnings measured in 1977 dollars to depict real trends was 95.1 in December 1986, compared with 97.4 in 1979. Average gross weekly earnings, reflecting also fewer hours of work opportunity, declined in 1977 dollars from $183.41 in 1979 to $170.30 in December 1986, a decline of more than 7.1 percent. Among other things, the minimum wage should promptly be lifted very substantially. The need for a national incomes policy remains pressing. But it would do more harm than good if not based upon the viable and fair balance among the major components in GNP which my recommended approach herein would bring into being. Practically all major national economic policies effect levels of consumption, and without national policies conducive to optimum consumption there can be no rounded national policies conducive to optimum overall economic performance.

In my selective discussion of needed national policies, I have not (except for Federal Budget policies) dealt very specifically with problems of major national concern, apart from pointing out that these should be treated as means adjusted to ultimate national purposes or goals. But some of these means are of sufficient importance and interest to require some additional treatment. The first and most important of these is the problem of inflation, the attempted public treatment of which has so often stunted real economic growth and contributed to the roller-coaster performance and high inflation.

The attempted use of the so-called "trade-off" between unemployment and inflation has always been unsupportable. During 1947-1953, the average annual rate of full-time unemployment was only 4.0 percent and was reduced to 2.9 percent in the last year, while the average annual rate of inflation was only 3.0 percent and reduced to 0.8 percent in the last year. Skipping over intervening periods which mostly point to the same lesson, from first quarter 1974 through first quarter 1975, when we suffered the biggest recession since the Great Depression and an unemployment rate averaging 6.0 percent, the average annual rate of inflation ranged from 11.0 percent for consumer prices to 16.7 percent for producer prices for finished consumer goods excluding food. During 1980-1984, the average annual rate of full-time unemployment was 8.3 percent, while the average annual rate of inflation was 6.0 percent. The so-called "boom" from fourth quarter 1983 ~~and~~ to second quarter 1984 was accompanied by a ~~vast~~ large reduction in inflation, the average annual rate for consumer prices being only 4.4 percent. To be sure, the period from second quarter 1984 to date has witnessed further reduction in inflation, accompanied by persistently high unemployment. But this latest experience cannot override the much longer evidence against the "trade-off", especially in that the drastic reduction in oil prices practically explains the price performance. The very least that may be concluded is that long-enduring periods of good economic performance have yielded far less price inflation than the roller coaster. And as earlier stressed, the value of a good economic performance far outweighs any marginal changes in price levels.

The reasons for these relative trends is that we live substantially under an administered price system, where prices are raised in an attempt to maintain profit objectives despite disappointing volume. It is also true that plant operations are far below the optimum increase cost per unit, which incites further price increases. The safest and most efficient road toward reasonable price stability is therefore attainment and maintenance of a reasonably full economy.

The problems of international competition and our unfavorable balances of trade and payments have also been stressed excessively at the expense of even more important matters. But they do merit some specific discussion. First of all, our deficits in these international matters are a mere bagatelle compared with the deficits in our domestic performance and enjoyment of domestic products. Instead of baying at the moon about the legitimate desire of many Americans to buy some product overseas rather than at home, or getting tied up in the tangles of protectionism, we should focus predominantly upon overcoming the income inadequacies and maldistributions which put brakes upon domestic consumption of domestic products. Taking care of this would reduce our international economic and financial problems to manageable or even negligible magnitudes. If we undertook the expansion of products where we are in short supply measured against the full need--housing, schools, and transportation being excellent examples--the domestic demand for steel would far exceed current capacities despite imports. In addition, as to manufactured products such as autos and steel, more fully utilized plants in a fully utilized economy would so greatly improve efficiency and productivity in the mass production "smokestack" industries, and so reduce per unit costs, that they would become far more competitive with the outside world.

Even if what I have just said is not entirely persuasive, the domestic labor displaced by growing world developments and abilities should be more than matched by the planned expansion of job opportunity in some lines of industry which is so sorely needed, and for which there can be no foreign competition. This is what purposeful adjustment rather than nonproductive complaints is all about. Those working overseas cannot compete with us by exporting to us housing or medical care, or education, or urban renewal, all of which we should expand rather than restrain. It is about equally true that the disturbing size of the fluctuations in the exchange rate of the dollar has reflected lack of international confidence in the stability and power of the U. S. economy and our capability for dynamic leadership. In essence, instead of accepting the alibis that foreign inreads are at the base of our domestic difficulties, we should recognize that we can best straighten out our world position by straightening out things at home. "The fault, Dear Brutus, is not in our stars, but in ourselves that we are underlings."

We should bear ever in mind that, contrary to the prevalent belief translated into national policies, i.e. that economic progress as conventionally conceived should take precedence over human or social justice, the truth is that there is no real dichotomy between the two. It is the deficiencies in social justice which have spawned the deficiencies in conventional economic progress, and overcoming the latter depends immensely upon overcoming the first.

The Catholic bishops' pastoral letter, issued on November 13, 1986, is a superb appeal, entitled Economic Justice For All. But it has received insufficnent attention--much less action--because even the well-intentioned and socially minded fear that its implementation would impede conventional economic progress. How wrong they are; the thwarting of the degree of economic justice we can afford and cannot afford to do without is at the heart of our economic trials and tribulations which stem from moral default.

There is a moral as well as economic default in the national policies we have been pursuing for all too long. We have been trying to adjust to limited shortcomings in the economy by contriving other shortcomings in response to them. We adjust Federal outlays to what it is claimed a stunted economy "cannot afford", instead of adjusting them upward to what a properly growing economy and an aspiring people need and can afford. We try to push consumption downward toward what a deliberately repressed economy seems able to serve, instead of adjusting it upward to levels essential to optimum overall performance. When Federal tax receipts are too low to cover the level of public outlays compatible with reasonably full resources and with meeting insistent human and other priority needs, we seek to cut outlays further instead of using the

Budget to promote the fuller resource use which would increase the tax take. When economic performance is deficient because some part of the economy is weak, we weaken other parts of the economy, although weakening these other parts compounds the original weakness.

The bloodletting of a physical nature which hastened the death of George Washington now finds its counterpart in the moribund economic bloodletting of today. In short, our national economic policies are bent upon compounding failures instead of generating successes. We are becoming a nation of what we must do without, instead of a nation dedicated to what we can and must do. We surrender to what is going wrong, and actual national policies aggravate what is going wrong, instead of reversing the process to get things going right. We attempt Maginot lines *against* adverse forces instead of marshalling a *pre-prosperity advance*. We forget the constructive dynamism of the 1946 and 1978 Employment Acts, and step backward to a defeatist and almost craven economic and social philosophy and practice.

Mr. Chairman and Members of the Committee: Is what I urge an ambitious and difficult program? Yes, but no more so than justified by the needs and innate capabilities and aspirations of the American people and their leadership. Difficult, yes, but by no means as difficult as what we have done successfully at historic times in the past, and not half as difficult / nor dangerous as trying to make work what we have learned cannot work. Difficult, but not more so than the actions mandated by the 1946 and 1978 laws under which this Committee was created and now operates.

The stakes are great beyond exact calculation. I said at the outset that I would not rely primarily upon forecasts. So I close with what is not a forecast; it is rather a current finding of what we must begin to do *now*, if we are to avoid continuation of so much that is intolerable in terms of our innate capabilities as a nation and a people, and instead commit ourselves to actualizing the real promise of America.

Senator **Sarbanes**. Thank you very much, Mr. Keyserling, for your statement.

Let me ask just a couple of questions. One is—and I really didn't have the time to pursue it, but Mr. Fiedler said, and I'm reading from his statement, "The combination of 6.5 to 7 percent unemployment and 3 to 4 percent inflation represents an acceptable compromise. We ought to realize when we are well off."

I wondered what you think of that comment.

Mr. **Keyserling**. Frankly, I couldn't think less of it. First of all, the 6.5 percent figure on unemployment is utterly wrong because, when you take into account the full-time equivalent of part-time employment and the "dropouts" discouraged by scarcity of job opportunity, the current true level of unemployment is above 10 percent, affecting directly 40 to 50 million people, and less directly, but powerfully affecting, the entire economy.

In the second place, I think there's absolutely nothing to the claim that a 6.5 percent unemployment and a 3–4 percent inflation rate is an appropriate "trade-off." It's not an appropriate "tradeoff" for two reasons. First, because we shouldn't even try to indulge in such a "trade-off." If a man comes into my office and has a job and I say to him, "You and 11 million others should be without jobs so that I can buy a steak dinner for my friends at the 21 Club in New York at a somewhat lower price increase than if you were employed. So go out and seek unemployment or accept it." This idea is immoral. It is un-American. It is bad economics and horrible social policy.

Second, the so-called "trade-off," and I know of no one who has traced this to the degree that I have and so persistently for so long—the "tradeoff" over any significant period of time has been completely refuted by the actual American experience. I have already cited the Truman years 1947–53, when we averaged 3.0 inflation and got it down to 0.9 percent in the last year. We averaged 4.0 percent unemployment, reduced to 2.9 percent in the last year. I could offer an example painting the same lesson during parts of the Kennedy-Johnson administrations. I could cite the Eisenhower administration, when CEA Chairman Arthur Burns thought that the 0.8 percent inflation he inherited was too high and the 2.9 percent unemployment too low. So he, taking into account also his influence upon the Federal Reserve Board, which he later headed, sought to change all this, and he did. He helped to double the unemployment rate and doubled or tripled the inflation rate. This is on the record.

I am not being "political" in my accounting. The same thing, in substance, happened under President Carter and CEA Chairman Charles Schultz. Jimmy Carter, very shortly after the Humphrey-Hawkins Act of 1978 was praised by him and which he pledged himself to observe, submitted an Economic Report deliberately asking for more unemployment and even a recession in order to fight inflation. The unemployment and the recession came, but the inflation soared way up.

During the biggest economic recession since World War II, we had the highest rate of inflation since the Civil War. When the economy took a sharp but brief spurt from late 1983 to mid-1984, the inflation rate went way down. And as to maintenance of a low inflation rate since then, which is cited to prove as against the tremendous weight by the evidence that the way to stop inflation is to have the economic situation worsen. First of all, it's too short a time to negate the long experience. Second, it's explained mostly not by other price trends but by a very sharp decrease in the price of oil. And its accompanied by the prediction even by the people supporting the "trade-off"—and supported by some of the very most recent facts—that inflation is going to rise again, despite economic stagnation.

Some of this is already happening. So there is nothing in the picture—economic, moral, and political—to justify trying to stunt the economy, to disserve the people, to frustrate the Government, by a deliberate stunting of the real rate of economic growth and deliberately fostering high levels of unemployment in the name of curbing inflation.

Senator SARBANES. In recent years they've started talking about the misery index where they add together the unemployment rate and the inflation rate in order to come up with what they call a misery index.

I have great difficulty with that because the way it's generally perceived is that it makes 1 point on the price index equal 1 point on the unemployment rate more or less, without trying to differentiate between those two things.

I wonder if you could address that concept.

Mr. KEYSERLING. Well, I think it's a complete mixing of apples and Eiffel Towers. I don't think the two have any connection with one another, as I've already indicated.

Moreover, I wouldn't want to go to the people who have become disemployed in the steel industry and the people who have become disemployed in the automobile industry and the young people coming onto the labor force without any chance to get a job, and say to them, "Would you please tell me about the misery effect of the inflation rate upon you?" They would say, "What the hell are you talking about? What has an effect upon us is that we are denied the right of opportunity to earn our living by the sweat of our brow and instead are being rejected by the American economy." So I think this "misery index" is just a pat catchy formula that is misleading or didn't prove anything.

Senator SARBANES. Now Mr. Fiedler suggested that if you tried to push the unemployment rate down that the inflation rate would go up.

Do you think there's a point at which that is in fact the case? And if so, at what point?

Mr. KEYSERLING. The total history, as I have tried to quantify it, is to the contrary. Now there are reasons for this. I really don't need to give the reasons because I believe my worthy friends have done so, but I can give reasons why, as I cited, we had the highest inflation rate since the Civil War with the highest unemployment since the Great Depression and the lowest inflation rate when we were doing best on the employment front. There are reasons for this.

The first reason is that we live largely in an administered price system. Farmers don't administer their prices, but look where they are. We live by and large in an administered price system, where prices are fixed by the vendor, and I have traced this, industry by industry. When an industry has found that its volume is disappointingly low, it raises its prices to try to compensate and to meet established profit targets. It's not like the old story of the 10 apples where if there are 11 buyers the price goes up and if there are 9 the price goes down. If I, as vendor, control the supply of the apples, when the price goes down and the buyer wants or needs them, I raise the price to try to cover my costs and get my desired profit although selling 9 instead of 10. This is how industry in the market works.

The second reason why the attempted "trade-off" does not work is productivity, most of the explanations which have not been correct. The main reasons why productivity has gone down have not been technological. The main reason is that if an industry is operating at 80 percent of capacity when it should be at 92 percent, it fortunately does not disemploy a corresponding percentage of workers. In other words, it employs less workers but more workers per unit of output. This raises per unit costs, which measure productivity. But this is a mathematical measurement of productivity, not a technologic measurement. Just the same, the increasing costs per unit lead to price increases.

So in the long run, there is nothing more conducive to higher prices than the faltering and stumbling performance of the economy, rather than performance at a reasonably high or full level. This is documented by the empirical observation which should be substituted for copy book maxims.

Senator **Sarbanes**. Well, thank you very much. We're pleased to have had you here as a witness.

The committee stands adjourned.

[Whereupon, at 12:35 p.m., the committee adjourned, subject to the call of the Chair.]

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